78-956

IN THE

Supreme Court of the United States

October Term, 1978

BERNARD JAY COVEN,

Petitioner,

-against-

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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To the Honorable Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your Petitioner, Bernard Jay Coven, respectfully pray that a writ of certiorari issue to review a determination of the United States Court of Appeals for the Second Circuit rendered June 2nd, 1978, affirming in part and reversing in part a judgment of the United States District Court for the Southern District of New York, which had enjoined petitioner from violating certain sections of the Securities Acts, after petitioner was held to have aided and abetted certain violations in connection with a public offering. The Court of Appeals reversed so much of the aforesaid judgment which had enjoined the petitioner from further violations of Rules 10b-5 and 10b-6 of the Rules under the Securities Exchange Act of 1934, as amended and affirmed so much of the said judgment as had enjoined the petitioner from further violation of Rule 10b-9 of the Rules under the Securities

Exchange Act of 1934, as amended (17 CFR 240.10b-9 and Title 15 U.S. Code §78j(b)). Trial in the United States District Court was had before Lawrence W. Pierce, D.J.

OPINIONS BELOW

The opinion of the Court of Appeals, whose judgment reversed in part and affirmed in part the judgment of the District Court is reported at ____F. 2d____ (2nd Cir. 1978); CCH Fed. Sec. L. Rep. ¶96,462 and is printed in Appendix B hereto, infra, p. 4a. The prior opinions of the United States District Court for the Southern District of New York are reported as follows: Opinion dated June 30, 1975 is reported at [1975-1976] CCH Fed. Sec. L. Rep. ¶95,222 and is printed in Appendix C, hereto, infra, p. 29a; Opinion dated August 19, 1975, on motion for reconsideration, is unreported and printed in Appendix C, hereto, infra, p. 57a. The portion of the said Judgment of the District Court which was affirmed by the Court of Appeals, and which is the subject of the within application is contained in ¶V thereof and is at p. 1a of Appendix A, hereto, infra.

JURISDICTION

The judgment of the Court of Appeals was rendered on June 2, 1978. A timely petition for rehearing and suggestion for rehearing en banc were both denied on August 7, 1978, without opinion. The orders of denial are printed in Appendix B hereto, infra, at p. 4a. On October 24, 1978, Mr. Justice Thurgood Marshall entered an order extending petitioner's time for the filing of this petition to and including December 4, 1978. On November 27, 1978, Mr. Justice Thurgood Marshall entered an order extending petitioner's time for the filing of this petition to and including December 15, 1978. The jurisdiction of this Court is invoked pursuant to Title 28 United States Code §1254(1). The basis for jurisdiction invoked in the District Court was Title 15 United States Code §§77v(a) and 78aa.

QUESTIONS PRESENTED FOR REVIEW

1. Whether in an action brought by the S.E.C. for a permanent injunction the petitioner can be held to have been an aider and abettor of a violation of Rule 10b-9 of the Securities Exchange Act and permanently enjoined upon a finding of simple negligence.

2. Where the District Court, in an action for permanent injunction brought by the S.E.C., permanently enjoined the petitioner as an aider and abettor of a violation of Rule 10b-9 of the Securities Exchange Act by applying a simple negligence standard, is it error, or such departure from the usual course of judicial proceedings as to call for the exercise of this Court's supervision where the Court of Appeals:

(a) Makes *de novo* findings that petitioner's aiding and abetting a violation of Rule 10b-9 "amounted to aiding and abetting of violations of §17(a) of the 1933 Act"; and upon such *de novo* findings holds,

(b) A simple negligence standard will support a permanent injunction for aiding and abetting a violation of §17(a) of the Act of 1933.

3. Assuming, *arguendo*, that the Court of Appeals may find *de novo*, that every violation of Rule 10b-9 of the 1934 Act amounts to a violation of §17(a) of the 1933 Act (and without specification of subsection thereof) can a permanent injunction issue against an aider and abettor in an S.E.C. action in the absence of scienter and upon the application of a standard of simple negligence.

4. Whether the petitioner can be held to be an aider and abettor of a violation of Rule 10b-9 of the 1934 Act where he has no knowledge or reasonable means of obtaining knowledge of the violation of the person he is said to have aided and abetted.

5. Where the Court of Appeals found that the District Court had erred in finding petitioner had aided and abetted violations of Rules 10b-5 and 10b-6 of the 1934 Act and affirmed only so much of the judgment as held that petitioner had aided and abetted a violation of Rule 10b-9 of the 1934 Act, was it

error, or such departure from the usual course of judicial proceedings for the Court to deny an application to remit the case to the District Court for determination as to whether an injunction is warranted in view of the partial reversal.

STATUTES INVOLVED

The statutes involved are 15 U.S.C. §78 j(b), Securities Exchange Act of 1934 §10b and Rule 240.10b-9 thereunder; and 15 U.S.C. §77q(a), Act of 1933 §17(a). The statutes and rules are set forth in Appendix D, hereto, infra pp. 70a-71a.

STATEMENT OF THE CASE

This was an action for injunctive relief brought by the Securities and Exchange Commission on July 5, 1973, against 11 persons, including petitioner, alleging violations of the Securities Laws in connection with the offering of the common stock of Dennison Personnel. The petitioner was the attorney for the Issuer. After trial before Pierce, D.J., the petitioner was held liable, as an aider and abettor of three violations: (1) in connection with the closing of the "all or none" portion of the issue, in violation of Rule 10b-9 of the Act of 1934; (2) the failure of the underwriters to comply with an obligation to use their "best efforts" to sell the entire offering, in violation of Rule 10b-5 of the Act of 1934 and §17(a) of the Act of 1933; and (3) the improper trading in the stock of Dennison by an underwriter while it was participating in distribution, in violation of Rule 10b-6 of the Act of 1934. On June 2, 1978, the Court of Appeals reversed the findings and judgment of the District Court with reference to violations "(2)" and "(3)" above and affirmed the judgment of the District Court with regard to violation "(1)" above. This petition has reference only to so much of the judgment which was affirmed.

On April 26, 1972, the Commission declared the Dennison issue effective. The offering provided that the underwriters would use their "best efforts" to sell 6,000,000 at a price of $.10 per share during a maximum 90 day business period following

the effective date. If at least 3,000,000 shares were not sold during that period all monies were required to be returned to subscribers. The Republic National Bank ("Republic") acted as Escrow Agent with respect to the minimum portion of the issue. The Bank was named as a defendant but after trial was held not liable. The Escrow Agreement provided that the Underwriters were to deposit with the Escrow Agent, not later than the third business day following the receipt, all funds received for the purchase of shares accompanied by appropriate letters of transmittal, listing the names and addresses of each of the purchasers and the number of shares purchased by each. With respect to the requirement of letters of transmittal and the information required therein, Republic ignored this obligation most of the time, made no demand upon the underwriters and never informed the petitioner, or anyone else, that such information was not being received. The Commission also required the underwriters of the issue to inform it, in writing, each week, during the selling period, of a list of the number of shares sold and the names of the respective purchasers. With the exception of an initial letter at the beginning of the selling period the Commission made no effort to compel underwriter's compliance with its requirement.

The Cover of the Prospectus, which was an exhibit, provided that all the monies were to be deposited with Republic and returned promptly to subscribers "unless at least 3,000,000 shares are sold." The risk factor section of the Prospectus provided that there was no provision for the return of funds "in the event at least 3,000,000 shares were sold." The underwriting agreement, which was likewise an exhibit, provided that "Until said 3,000,000 shares of stock are sold" the underwriters shall deposit all funds with Republic. The Court of Appeals emphasized in its opinion a section of the Escrow Agreement which provided that if 3,000,000 shares were sold Republic would deliver to [Dennison] and to the underwriters its checks in the amount of $255,000 and $45,000 [the commission of the underwriters on sale of the minimum portion] respectively "provided that collected funds sufficient to cover such payments shall be in

the Escrow Account on the Delivery Date."[1]

A closing was had on June 12, 1972. On that date there was in the Escrow account the sum of $231,003. Prior to June 12, both underwriters of the issue had deposited gross funds into the account,[2] with the exception of a selling group member of one of the underwriters who had deducted its commissions of $1,582.50. Carlton Cambrige & Co., Inc., one of the underwriters appeared at the closing by its president, Joseph Rega, with a check in the sum of $31,503.75 which was not certified. Rega stated this check of $31,503.75[3] was a net check, all commissions due to date having been deducted. Republic, after consulting with its attorneys typed a letter signed by Rega confirming the deduction of commissions and that nothing was due to Carlton. The Issuer and the underwriters pressed for a closing but because the Carlton check was not certified the closing was adjourned in escrow, subject to clearance of the check. The parties also stipulated that delivery of ordered shares would first be made to the bank for counting and verification,[4] instead of the usual course of direct delivery from the Transfer Agent to the

1. This portion emphasized by the Court of Appeals is boiler-plate intended to prohibit partial payments and has no application in the manner suggested by the Court's opinion. On the trial the Commission conceded that it had had an opportunity to settle the ambiguities between the Prospectus and the various exhibits with reference to the escrow account before the effective date.

2. Carlton prior to June 12 had deposited in the escrow account gross funds sufficient to cover 1,984,860 shares. The balance came from the co-underwriter and its selling syndicate.

3. The opinion of the Court of Appeals erroneously states this check in the amount of $31,493.75. The Court inadvertently overlooked an exhibit in the appendix which indicated that Republic deducted a $10 charge for collection from the check proceeds and credited the difference to the account.

At trial Carlton's bank account from which it drew checks for transmittal to Republic showed a balance of $75,000 minimum for the period of June 12 to June 21, 1972, which sum represented $34,000 in excess of the commissions deducted on this last check to Republic.

4. The Escrow Agreement executed by the bank and filed with the Commission provided that the underwriters with each transmittal of funds to the bank would accompany the same with information indicating purchaser name, and address and the number of shares purchased.

underwriters. The latter precaution was taken as a result of a difference between respective counsel as to the interpretation of various documents connected with the offering in light of the fact that the escrow account indicated a substantial number of shares sold in excess of the minimum required, but did not show a minimum gross of $300,000, due to the final commission deduction by Carlton.

On June 13, Carlton's co-underwriter advised Republic by letter that 351,000 shares had been sold by it directly and through a selling group, that a member of the group had previously deducted $1,582.50 as commissions prior to remittance and requested the balance of commissions due. On June 13, the petitioner advised Republic by letter that 3,075,000 shares had been sold, that the shares had been ordered from the Transfer Agent for delivery to Republic in accordance with the June 12 arrangement, and when delivered would be full paid, non-assessable and registered. The shares were subsequently delivered to Republic by the Transfer Agent. On count it was noted that 3,073,500 shares were delivered to Republic by the Transfer Agent. The petitioner was notified on June 19, by Republic that his June 13 letter was in error by 1500 shares (these shares represented $150. at the offering price of ten cents), but the difference did not affect the minimum required sale of 3,000,000 shares. The petitioner assumed that a clerical error had been made but before any further opportunity to ascertain the facts was had, the Issuer, without consulting with petitioner, its attorney, authorized in writing on June 21 the issuance of 3,073,500 shares, a necessary closing document, and Republic after consulting with its own attorneys, as set forth in an internal bank memorandum, determined that the minimum requirements had been met and proceeded to distribute both funds and shares.

Carlton ordered 2,724,000 shares from the Transfer Agent and of these, 1,000,145 were requisitioned in "street name" (i.e., in Carlton's name). The ordering of shares of an issue in "street name" was not unusual. The District Court found that a large number of shares did not correspond to any customers of Carlton and hypothesized that Carlton had subtracted the

number of shares sold by its co-underwriter from the 3,075,000 figure supplied by petitioner and had made up the difference in actual sales by subscribing for the difference in "street name" shares. The petitioner's letter of June 13 had been directed only to bank and, of course, petitioner had no way of determining whether the sales made by Carlton were bona fide. Also then unknown to petitioner was that Republic was almost totally remiss in failing to observe the requirement of the escrow agreement filed with the Commission, that with each transmittal of funds it obtain from the underwriters the names and addresses of all purchasers and the number of shares purchased by each. The petitioner reasonably believed that the bank would verify the shares delivered to it against this information. On the trial, Republic, for the first time, revealed that much of this information was either lost, mislaid or not received by it.

The District Court concluded that Carlton and Rega had "contrived figures calculated to give the appearance that the minimum portion of the issue had been sold" and that with respect to this the Court concluded that "representing that the offering would be on an 'all or none' basis violated Rule 10b-9 as well as §10b of the 1934 Act "CCH ¶95222 p. 98, 145. The Court held petitioner as an aider and abettor in that the petitioner was negligent in failing to investigate *"exactly* how many shares had in fact been sold" (emphasis in Court's opinion p. 98, 147). On reconsideration the Court added, that the petitioner had *"some* limited grounds[5] for asserting that 3,000,000 shares had been sold" (emphasis in opinion). The Bank was found not to be an aider and abettor on the ground that Republic "had no knowledge or any reason to suspect" that the figures submitted to the Transfer Agent by Carlton were in part contrived (at p. 98, 148). The District Court in finding the petitioner as an aider and abettor of a 10b-9 violation employed a simple negligence standard, stating that "Knowledge that a violation is being committed and intent to further the illegal act is not required" (p. 98, 146). As indicated above, that part of

5. These "grounds" included testimony by the petitioner that he had obtained the figure of 3,075,000 shares sold from the underwriters.

the District Court judgment having reference to this violation enjoined the petitioner from further violation of Rule 10b-9 of the 1934 Act.

The Opinion of the Court of Appeals

The petitioner contended, among other matters, that the District Court had applied an incorrect legal standard, citing this Court's holding in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). The Court held that notwithstanding that petitioner was enjoined as an aider and abettor of a violation of Rule 10b-9 "his conduct amounted to an aiding and abetting of violations of §17(a) of the 1933 Act" (Slip Op. p. 3221). The Court did not bother to explain how the petitioner could have aided and abetted "violations of §17(a)" when the principal whom the petitioner was said to have aided and abetted was found with respect to the particular violation to have violated Rule 10b-9 of the Act of 1934. The use of the plural of "violations" of §17(a) was not inadvertent as the Court made no specific effort to indicate which of the subsections of §17(a) the "amounted to" had reference. As will be indicated herein various Circuits are in conflict with respect as to whether this Court's opinion in *Hochfelder* has significance to various of the subsections of §17(a). The Court stated that in "one important respect" the instant case differed from *Hochfelder* was that here the SEC "charged appellant" with a violation of §17(a) as well as 10b (sic). Assuming, *arguendo,* that such a respect is "important," which petitioner disputes, the Court was inadvertently inaccurate.[6] The Court also recognized as a casualty of its opi-

6. The Commission in a style which has become characteristic alleged violations of every conceivable section of the 1933 and 1934 Acts in shotgun approach. However, the Fourth Cause of Action of the complaint charged petitioner with aiding and abetting a violation of Rule 10b-9 of the 1934 Act. It did not charge an aiding and abetting of §17(a) of the 1933 Act. The case was tried with respect to that portion as a Rule 10b-9 violation; the District Court concluded that a Rule 10b-9 violation had occurred and that petitioner had aided and abetted the same and an injunction was requested by the Commission and granted by the Court enjoining petitioner from further violation of Rule 10b-9.

nion that the consequence might well be to negate limitations on private recoveries for negligence contained in §§11,12(2) and 15 of the 1933 Act, assuming a private right of action exists under §17(a), again as to which conflicts between the various circuits exist (Slip Op. p. 3234 n. 15). The Court added, by way of dictum that petitioner's letter of June 13 to Republic amounted to a kind of "reckless disregard," which the Court said it had recently held sufficient to support a private 10b action. The case cited involved a fiduciary relationship, a factor not present here. That contention was not made or passed upon by the District Court, the Commission then relying on simple negligence. *Hochfelder* was then not yet decided by this Court.

REASONS FOR ALLOWANCE OF WRIT

I

CERTIORARI SHOULD BE GRANTED TO RESOLVE CONFLICTS AMONG THE CIRCUITS AS TO WHETHER SCIENTER MUST BE PROVEN AGAINST ONE CHARGED AS AN AIDER AND ABETTOR OF A VIOLATION OF RULE 10b-9 OF THE ACT OF 1934 AND OF §17(a) OF THE ACT OF 1933

In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976) this Court held that in a private action for damages under §10b of the 1934 Act and Rule 10b-5, allegation and proof of scienter was essential. The Court based its decision upon both the history and language of §10b. The Court concluded that the wording of "manipulative or deceptive," when used in conjunction with "device or contrivance" connote intentional misconduct. While this Court did not specifically reach the issue of aiding and abetting, it is suggested that, upon close examination of the opinion, this Court resolved the issue, as requiring proof of scienter. The opinion considered Ernst & Ernst as a principal. It would appear logical that the imposition of liability applicable to a principal should be lower than the threshold applicable to one who is sought to be held

secondarily liable. This Court indicated in Note 7 of its opinion that some form of scienter would be required, citing favorably various cases favoring that point of view.[7] In *Hochfelder* the Commission appeared as amicus curiae.

While the District Court in *S.E.C. v. Bausch & Lomb,* 420 F. Supp. 1226 (S.D.N.Y. 1976) has held that *Hochfelder* is applicable to S.E.C. enforcement actions and that scienter must be alleged and proven, at least with respect to Rule 10b actions, the Second Circuit has here taken the position that the question remains unresolved in that Circuit (Slip Op. p. 3231 n. 10). In *SEC v. Commonwealth Chemical Securities, Inc.,* ___F.2d___ (2nd Cir. 1978), CCH Sec. L. Rep. ¶96,351, the Court recognized that the question was one that must be determined by this Court, stating that the question of whether "a showing of negligence suffices to support an injunction in an action by the SEC is a matter of great importance on which the final word will not rest with us" (p. 93,198). Conflicts have arisen in the various circuits with reference to the application of this Court's determination in *Hochfelder* to the granting of any relief, absent proof of scienter, pursuant to §10b and the 10b group of rules under the Exchange Act as well as demands for relief pursuant to §17(a) of the 1933 Act. With respect to the latter some Courts have refined the distinction holding one subsection not to require proof of scienter (subsection 2) and requiring proof of scienter with respect to subsections 1 and 3 thereof. Other circuits have no hesitancy in finding scienter a required element of proof with respect to all subsections of §17(a). The First and Second Circuits with the same lack of hesitancy find scienter not required at all. The differences in opinion as to the application of *Hochfelder,* have led at least two courts who, recognizing how volatile the question is, to decline, for that reason, to make pre-trial rulings in enforcement cases, as to

7. The Court's citations were preceded by the signal "See." This is to be compared with the signal employed by the Court in Note 12 of "Cf" with reference to the citation of *SEC v. Capital Gains Research Bureau, Inc.* "Cf" is used when "Cited authority supports a statement, opinion or conclusion different from that in the text but sufficiently analogous to lend support to the text" A Uniform System of Citations Harvard Law Review 11 ed. p. 87.

whether scienter was a necessary element of Commission proof seeking §10b and §17(a) relief by injunction. As will be noted hereinbelow the District Court for the District of Columbia, citing the instant case, found the question one of importance and requiring the ultimate answer from this Court. The application of *Hochfelder* to §10b and §17(a) enforcement actions particularly with respect to aiding and abetting is a question that has been thoroughly debated by courts and legal scholars and is presently ripe for ultimate determination by this Court.

In *Sanders v. John Nuveen & Co., Inc.*, 554 F. 2d 790 (7th Cir. 1977) (SEC appearing as amicus curiae) the Court held that in applying *Hochfelder* judgment for plaintiff cannot be sustained under §17(a) absent proof of scienter. The Court found that with respect to subsections (1) and (3) of §17(a) "Proof of scienter is unquestionably required" as these subsections, the Court said, refer to fraud. With respect to subsection (2) of §17(a) the Court held that to impose liability without proof of scienter would negate the express provisions Congress provided for civil liability in sections 11 and 12(2) of the 1933 Act, citing *Hochfelder* with reference to this Court's comments as to a similar problem in connection with §10b, 425 U.S. at 210. In *SEC v. American Realty Trust, Inc.*, 429 F. Supp. 1148, reversed ___F2d___ (4th Cir. November 17, 1978) the defendant was charged with violations of §10b, Rule 10b-5 thereunder and §17(a). The District Court in reliance upon *Hochfelder*, held that scienter was a necessary element in both 10b and 17(a) enforcement actions. The Court of Appeals, reversing, held that §17a(2) did not require proof of scienter. In *SEC v. Cenco, Inc.*, 436 F. Supp. 193 (N.D. Ill. 1977), the Commission sought to enjoin violations of §10b and §17(a). The Court distinguished decisions of the Second and Tenth Circuits and held that scienter is an essential element whether injunctive relief is sought under §10b or §17(a). The Court noted that if statutory construction requires scienter in private damage actions it is also mandated in an injunction action brought under the same statute, as the standard should be equally applied whether the litigant is a private person or the Commission. In *American Realty Trust*, cited supra, the District Court came to the same

conclusion, noting the comment of the dissenters in *Hochfeld*, 425 U.S. at 217,218. In *Malik v. Universal Resources Corp.*, 425 F. Supp. 350 (S.D. Cal. 1976) the defendants were charged with violations of Rule 10b-5 and §17(a). Applying the principles of *Hochfelder*, the Court found that the element of scienter was a requirement with reference to both 10b and 17(a) and specifically found that with respect to §17(a)(2) scienter was an essential element of proof. The Court noted that to hold that scienter is not required under both §10b and §17(a) would create an undesireable assymetry of coverage between the two Acts "and would signal the easy circumvention and swift desuetude of *Ernst [& Ernst v. Hochfelder]*." In *Little v. First California Co., [1977-1978] CCH. Sec. L. Rep.* ¶96,226 (D.C. Arizona 1977), the Court considered a motion for summary judgment based upon a complaint charging violations of Rule §10b-5 and of §17(a). The Court held that scienter must be demonstrated as an element of proof under Rule 10b-5 and all subsections of §17(a) finding the reasoning of the 7th Circuit in *Sanders*, cited supra, persuasive. The Court stated, that "Proof of scienter is unquestionably required as to subsections (1) and (3) of §17(a)" and to hold otherwise with respect to subsection (2) would, negate the procedural restrictions of §§11 and 12(2) of the 1933 Act. The Court also noted that the 9th Circuit in *White v. Abrams*, 495 F. 2d 724,727 n. 2 (9th Cir. 1974) had already concluded prior to *Hochfelder* that the elements of proof in an action under Rule 10b-5 and §17(a) were the same. In *SEC v. Southwest Coal & Energy Company, et al*, 439 F. Supp. 820, 824 (W.D. La. 1977), the District Court, came to a contrary conclusion, as to §17(a)(2) holding it did not require proof of scienter. The Court, however, held that *Hochfelder* required proof of scienter in SEC enforcement actions, based upon Rule 10b-5 as it was immaterial whether the plaintiff was a private person or the SEC. The Court cited to the First Circuit's opinion in *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976) as to its ruling with respect to §17(a)(2).

In *SEC v. Hart*, CCH Sec. L. Rep. ¶96,454, (D.C. Columbia 1978) the Court enjoyed a different reading of *Hochfelder*. The Court held that in injunctive actions under 10b-5 the

scienter is not an element that the Commission must prove. In *SEC v. Penn Central Co., CCH Sec. L. Rep.* ¶96,461, (E.D. Pa. 1978),the question was whether the SEC was required to prove scienter in enforcement actions pursuant to Rule 10b-5 and §17(a). The question question arose on pre trial motion to dismiss. Given the plethora of conflicting opinions in the various circuits the Court threw up its hands and stated "Given the volatile nature of this area of the securities law and the suddenness with which judicial tide might turn in either direction, we ought not to bind ourselves now by deciding the consequence of the SEC's failure to establish scienter at trial" (p. 93,672). In *SEC v. Schlitz Brewing Co.*, CCH Sec. L. Rep. ¶96, 464 (E.D. Wis. 1978) the Commission sought an injunction for alleged violations of Rule 10b-5 and §17(a). On motion, prior to trial, the question was did scienter have to be proven. The Court in *Schlitz* took the same position as the Court in *Penn Central* citing to it. In *SEC v. Savoy Industries, Inc.*, CCH Sec. L. Rep. ¶96,497 (D.C. Cir. 1978), the Court citing to the instant case, as an illustration, stated that the determination of whether scienter is required in §10b and §17(a) enforcement actions are "important questions, the resolution of which *Ernst & Ernst v. Hochfelder* has made less clear." The Court came to no conclusion in its opinion, as it remanded the action for further findings of fact. In *SEC v. Geotek*, CCH Sec. L. Rep. ¶96,520 (N.D. Cal. 1978) [also same title 426 F. Supp. 715 (1976) with respect to other defendants], the Court in its latter opinion held that although in an SEC injunction action violations of a *principal actor* of Sections 17 (a) and 10b and Rule 10b-5 can be predicated on negligent conduct alone, to hold one as an aider and abetter can be sustained:

> "[O]nly if some other party has committed a securities law violation, if the accused had general awareness that his role was part of an overall unlawful activity, and if the accused aider and abettor knowingly and substantially assisted the violation. *S.E.C. v. Coffey*, 493 F. 2d 1304, 1316 (6th Cir. 1974), cert. den. 420 U.S. 908 (1975); contra *S.E.C. v. Spectrum, Ltd.*, 489 F. 2d 535 (2nd Cir. 1973)" p. 94,039.

The Court added, that "it is not at all clear that injunctive relief is appropriate where only negligent conduct is found, since by definition negligence is inadvertent and unintended" (p. 94,043).

In *S.E.C. v. National Student Marketing Corp. et al*, CCH Sec. L. Rep. ¶96,540 (D.C. Col. August 31, 1978), the Court reviewed the decisions in the various circuits with respect to he level of culpability required in SEC enforcement actions, including the present case. The Court noted that the determination of the level of culpability required was now far from certain. The Court stated that the position that negligence is sufficient "has been significantly eroded" by *Hochfelder* with respect to 10b actions. "Similar confusion," the Court said, prevails with respect to the role of scienter in relation to injunctive actions for violations of §17(a). The Court concluded that these are "important issues, the resolution of which would be welcome to the securities bar." The conflicts among the circuits both as to rationale and conclusion being so diverse such resolution can only come from this Court. The necessity of guidance from this Court is emphasized by the spill-over effect of the *Hochfelder* opinion into state court domain. Arizona securities Law, A.R.S. §44-1991 is identical with its federal counterpart §17(a) of the Act of 1933. In *Greenfield v. Cheek*, CCH Sec. L. Rep. ¶96,560 (Arizona Court of Appeals, September 1978), the Court, after a scholarly examination of the conflicting opinions of the various circuits and in light of this Court's opinion in *Hochfelder* concluded that uniform treatment of Rule 10(b)5 and §17(a) is necessary and that proof of scienter is a required element to be proved under §17(a) and thus under its state law counterpart. A Judge of the Court of Appeals panel in *Greenfield* who had concurred in a previously contrary determination, specially concurred in both the reasoning and result of the *Greenfield* opinion, stating that "he was now convinced that scienter should be required as an element." Three days prior to *Greenfield*, the District Court in *SEC v. Western Geothermal & Power Corp.*, CCH Sec. L. Rep. ¶96,590 (D.C. Arizona September 16, 1978), had occasion to consider the question in the context of a motion to dismiss the complaint. The commis-

sion alleged violation of §10b and asserted that the same violations were violative of ‡17(a). The defendants moved to dismiss the alleged violations of §10b and §17(a) on the ground that scienter was not alleged, citing *Hochfelder.* The Court held that the commission need not prove scienter in any enforcement action regardless of the section, negligence being sufficient.

Eminent authorities are in conflict as to the *Hochfelder* resolution of the necessity of scienter as an element in SEC enforcement actions and add to the confusion already indicated in the various circuits. See, e.g., *Ernst & Ernst v. Hochfelder; An Anti-Landmark Decision,* 22 N.Y.L. School L. Rev. 29 (1976); *Comment, Scienter and SEC Injunction Suits,* 90 Harv. L. Rev, 1018 (1977); *The Scienter Question,* 5 Hofstra L. Rev. 831 (1977); *Injunctive Actions, A Reappraisal in the Light of Hochfelder,* 51 N.Y.U. L. Rev. 767 (1976).

II.

THE HOLDING OF THE COURT OF APPEALS THAT PETITIONER'S CONDUCT "AMOUNTED TO AN AIDING AND ABETTING OF A VIOLATION OF §17(a)" AND USING SUCH PREMISE TO SUSTAIN AN INJUNCTION BASED UPON RULE 10b-9 WAS VIOLATIVE OF DUE PROCESS AND IN ANY EVENT WAS SUCH A DEPARTURE FROM THE USUAL COURSE OF JUDICIAL PROCEEDINGS AS TO REQUIRE THIS COURT'S SUPERVISION.

The District Court found that the petitioner had aided and abetted a violation of Rule 10b-9 and enjoined the defendant accordingly. The District Court based its injunction upon a finding of simple negligence. The Court of Appeals, when faced with a clear question as to the applicability of a negligence standard to an alleged aiding and abetting of a Rule 10b-9 avoided the issue by arbitrarily placing a different label on the alleged violation, saying that the violation "amounted to a violation of §17(a)". Using such semantic springboard the reader of the opinion is advised that a §17(a) violation may in the Second Circuit, be predicated wholly on negligence. This holding, if permitted to stand signals, as the Court in *Malik v. Universal Resources Corp.,* 425 F. Supp. 350 (S.D. Cal. 1976) prophesied, "the easy circumvention and swift desuetude of *Ernst & Ernst v. Hochfelder.*" The Commission has been swift to enter the breach created e.g., in *SEC v. Western Geothermal & Power Corp.,* cited supra the complaint cites the same conduct as both violative of §10b and §17(a). But more, having reached §17(a) as above noted the Court of Appeals was faced with a choice of three subsections. It appears to have opted with all three, with greater emphasis on subsection 2. Even with respect to §17(a)(2) the Court made no effort to square the requirements of that subsection that "the seller actually 'obtain money or property by means of the false statement or half truth" 3 Loss, *Securities Regulation* (2nd Ed. 1960) p. 1439 with the facts of the petitioner's case.

The District Court found that the principal defendant whom the petitioner was found to have aided and abetted had violated Rule 10b-9. How one could aid and abet a §17(a) violation under such circumstances was not explained, as indeed it could not be. The Court of Appeals has thus rewritten the basically accepted rules with regard to aiding and abetting. It now appears that the principal can be held to have violated one rule and his alleged aider and abetter found to have aided and abetted the violation of another rule for which the principal was not found liable. Thus the petitioner has been effectively enjoined by a determination that in effect he violated another rule for which no trial was ever had and upon which the District Court, accordingly, made no findings. It is submitted that the petitioner has been deprived of due process of law. Further, it is submitted that this Court should assert its supervisory powers, as the decision of the Court of Appeals is a departure from the usual judicial rules. If the rationale of the Second Circuit is sustained a conviction for aiding and abetting will be upheld in the absence of proof the principal's guilt on the theory that the conduct of the aider and abettor "amounted to" aiding and abetting some other crime not charged against the principal.

III.

THE COURT OF APPEALS FINDING THAT THE CONDUCT OF THE PETITIONER "AMOUNTED" TO A KIND OF 'RECKLESS DISREGARD' WAS ERRONEOUS AND DID NOT MEET THE EQUIVALENT CRITERIA OF SCIENTER.

The District Court, as above stated, made no findings of recklessness with respect to petitioner's conduct. The Court of Appeals however characterized petitioner's conduct as "amounting to" reckless disregard and cited *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F. 2d. 38 (2nd Cir. 1978). In *Rolf* the defendant owed the plaintiff a fiduciary duty, a factor not present here. In *Berman v. Richford Industries,* CCH Sec. L. Rep. ¶96,518, p. 94,015 n. 17, (S.D.N.Y. July 1978), the Court stated:

> "Gross negligence is not a synonym for "recklessness," a degree of culpability which the Second Circuit post Hochfelder has held to support recovery under Section 10b, at least where defendant owes plaintiff a fiduciary duty. *Rolf v. Blyth, Eastman Dillon & Co.* Whereas the former implies an irrational failure to perceive a danger, the latter connotes persisting in the face of perceived danger, although the specific harm resulting may not be intended. ***."

In *Sanders v. John Nuveen & Co., Inc.*, cited supra, the Seventh Circuit held in view of *Hochfelder*

> "[T]he definition of "reckless behavior" should not be a liberal one lest any discernable distinction between "scienter" and "negligence" be obliterated for these purposes . . . We perceive it to be not just a difference in degree, but also in kind." at p. 793.

See, *Lake v. Kidder, Peabody & Company, Inc., et al,* CCH Sec. L. Rep. ¶96,509 (D.C. No. Dist. Ind. 1978).

IV

IN REVERSING A SUBSTANTIAL PORTION OF THE DISTRICT COURT'S FINDINGS AND JUDGMENT THE COURT OF APPEALS SHOULD HAVE REFERRED THE CASE TO THE DISTRICT COURT FOR DETERMINATION AS TO WHETHER AN INJUNCTION WAS THEN WARRANTED.

The Court reversed the District Court's findings and judgment that the petitioner had aided and abetted violations of 10b-5 and 10b-6 and affirmed so much of the judgment as enjoined the petitioner with respect to Rule 10b-9. It is submitted that the Court erred in denying petitioner's request made upon application for rehearing for such reference. The determination of whether an injunction should issue is a matter of discretion properly to be first decided by the Court which heard the evidence and observed the witnesses. An examination of the District Court opinion patently indicates that the Court, in considering the totality of circumstances was plainly influenced to issue an injunction upon finding 10b-5 and 10b-6 aiding and abetting violations. The conduct of the petitioner was not "wilfull, blatant and outrageous" as the conduct characterized in *SEC v. Manor Nursing Centers, Inc.*, 458 F. 2d at 1101 (2nd Cir. 1972). It was an isolated incident, unlikely to recur and insufficient to warrant an injunction *SEC v. National Student Marketing,* CCH Sec. L. Rep. ¶96,540 (D.C. Dist. of Col. 1978). As in *National Student,* the petitioner, at the closing was "under some pressure to determine a course of action." The petitioner has not been found prior to this case or since it to have violated any rule or law and more than six years have elapsed since the complained of incident. Three years elapsed before judgment was entered in this case, during all of which time the Commission sought no interlocutory relief. Such inaction on the part of the Commission argues strongly against the need for injunction. In *National Student,* the Court properly considered the effect of an injunction with respect to an attorney and noted that despite the finding in that case of scienter

an injunction was not warranted and noted the absence of persistent misconduct and considered the professional responsibilities of the defendant attorneys to conform their conduct to the dictates of the law.

In the case at bar the petitioner was totally without ability to determine whether the sales of the offering by the underwriter were to bona fide customers. If the underwriter had been compelled to deposit gross funds into the escrow account on his last check at the closing this fact would not have added to the ability of the petitioner, attorney for the issuer to determine the bona fide quality of the sales under the offer. The petitioner was under pressure to close from his client, who claimed that delay might result in bankruptcy of the issuer. A deposit of gross funds at the closing would if it had been required at the closing plainly indicate that the issue minimum had been oversold and result in an exchange of checks, as the underwriter would be entitled to his commissions. Neither did petitioner have any knowledge that the escrow bank was derelict in performing its obligations. The Commission likewise gave no inkling of the fact that it was not getting the reports on sales required to be made by the underwriters to it in writing.

It is submitted that the Court of Appeals erred in failing to remand the action to the District Court to determine whether an injunction was warranted in view of the partial reversal.

CONCLUSION

The case is one where petitioner, an attorney has been enjoined under circumstances indicative of deviations from established law. It is further manifest that the present application presents meritorious and arguable questions of a kind likely to arise in other cases and calling for authoritative disposition by this Court. Several circuits, including the Second, as indicated herein have noted that a final determination of the issues here raised with respect to the application of this Court's opinion in *Hochfelder* must come from this Court. There are sharp conflicts of opinion among the several Courts of Appeals as well as in District Courts of the several circuits. There are also conflicts between District Courts in the same circuit and at least in one instance, there is a conflict between the highest State Court and the District Court of that State (Arizona). The instant case has been cited in cases on either side of the conflict. Legal authorities have mirrored the sharp conflict of opinions in numerous law review articles (at least three law review articles are presently in preparation with respect to the instant case and its holding). The within petition is filed in good faith and not for purposes of delay.

For the foregoing reasons, your petitioner respectfully prays that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit to the end that this cause may be reviewed and determined by this Court; that the determination, order and so much of the judgment of the said Court of Appeals as affirms the judgment of the District Court may be reversed, and that petitioner be granted such other, further and different relief as may seem proper.

Dated: New York, New York
December 14, 1978

Respectfully submitted,

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BERNARD JAY COVEN,
Of Counsel.

APPENDIX "A"
SO MUCH OF JUDGMENT APPEALED FROM ENTERED AUGUST 20, 1975

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

-against-

JOSEPH REGA, JR., CHRISTIAN-PAINE & CO., INC.
CARLTON-CAMBRIDGE & CO., INC.
BERNARD JAY COVEN, ROBERT E. LEVIN
THE REPUBLIC NATIONAL BANK OF NEW YORK
ROSS W. PASCALL, LOUIS LEVINE,
BERNARD A. COLLOFF, JOSEPH CORVINO,
HAROLD WEINBERG

Defendants.

Plaintiff, Securities and Exchange Commission ("Commission"), having filed its Complaint herein on July 5, 1973, and the defendants having appeared herein and a trial on the merits having been held between January 2, 1974 and March 7, 1974, and the Court having issued an opinion in this matter on June 30, 1975 containing the Court's findings of fact and conclusions of law pursuant to Rule 52(a) of the Federal Rules of Civil Procedure, it is hereby

ORDERED, ADJUDGED AND DECREED that:

***

V. Defendants Joseph Rega, Jr., Christian-Paine & Co., Inc., Carlton-Cambridge & Co., Inc. and Bernard Jay Coven, their officers, directors, nominees, servants, employees, successors, agents, attorneys, assigns and those persons in active concert or participation with them, and each of them, are hereby permanently enjoined from directly or indirectly, making use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, in connection with the offer or sale of the common stock of Dennison Personnel, Inc., or any other security, to make any representation:

(1) to the effect that the security is being offered or sold on an "all or none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless (A) all of the securities being offered are sold at a specified price within a specified time, and (B) the total amount due to the seller is received by him by a specified date; or

(2) to the effect that the security is being offered on any other basis whereby all or part of the consideration paid for any such security will be refunded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering or distribution being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless (A) a specified number of units of the security are sold at a specified price within a specified time, and (B) the total amount due to the seller is received by him by a specified date.

***

Dated: New York, New York
August 19, 1975

s/Lawrence W. Pierce
LAWRENCE W. PIERCE
U.S.D.J.

JUDGMENT ENTERED 8/20/75

s/Raymond J. Burghardt
Clerk

APPENDIX "B"
OPINION OF COURT OF APPEALS
ENTERED JUNE 2, 1978

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 558—September Term, 1977.

(Argued January 16, 1978 Decided June 2, 1978.)

Docket No. 75-6080

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—against—

BERNARD JAY COVEN,

Defendant-Appellant.

Before:

MOORE, SMITH and MANSFIELD,

Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Lawrence W. Pierce, *Judge,* enjoining appellant from violating certain sections of the securities acts after he was held to have aided and abetted certain violations of those sections in connection with a public offering.

Affirmed in part and reversed in part.

BERNARD JAY COVEN, P.C., New York, N.Y., *for Defendant-Appellant.*

DAVID FERBER, Solicitor to the Commission, and GLYNN L. MAYS, Attorney, Securities and Exchange Commission, Washington, D.C. (Sue E. Auerbach, Attorney, Securities and Exchange Commission, Washington, D.C., of counsel), *for Plaintiff-Appellee.*

MANSFIELD, *Circuit Judge:*

On July 5, 1973, the SEC commenced this action for injunctive relief pursuant to 15 U.S.C. §§77t(b) and 78u against 11 persons, including appellant, Carlton-Cambridge & Co. ("Carlton"), its president, Joseph Rega, Jr., and the Republic National Bank of New York ("Bank"), charging numerous violations of the federal securities laws in connection with a public offering of the common stock of Dennison Personnel, Inc. in 1972 and the subsequent manipulation of its market price.[1] Appellant allegedly participated in several of these violations. His conduct in each instance was claimed to violate §17(a) of the 1933 Act, 15 U.S.C. §77q(a).

After a non-jury trial Judge Pierce filed an opinion recording his findings and conclusions of law on June 30, 1975. Appellant was held liable as an aider and abettor of three violations: (1) the improper closing of the "all-or-none" portion of the Dennison issue in violation of SEC Rule 10b-9, (2) the underwriters' failure to comply with their obligation to use "best efforts" to sell the entire offering, violating Rule 10b-5 and §17(a) of the 1933 Act, and (3) Carlton's improper trading in Dennison stock

1 The complaint, which covered 21 pages, alleged myriad violations of §§5(b) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§77e(b) and 77q(a), §§10(b) and 15(c)(2) of the Securities Exchange Act, 15 U.S.C. §§78j(b), 78o(c)(2) (1970), and Rule 10b-5, 10b-6, 10b-9, and 15c2-4, promulgated thereunder.

undertaken while it was participating in its distribution, which violated Rule 10b-6. Judge Pierce concluded that an injunction was the appropriate remedy. In a second opinion responding to appellant's motion for reconsideration, Judge Pierce declined to alter his conclusions concerning appellant's liability and the propriety of an injunction. Consequently, he entered an order enjoining appellant from committing future violations of the sort he was found to have aided and abetted.

For reasons set out below, we affirm the lower court's order with regard to one of the violations attributed to appellant—the improper closing of the escrow account—on the ground that his conduct amounted to aiding and abetting of violations of §17(a) of the 1933 Act. However, we reverse as to the other two violations—Carlton's improper trading and the underwriters' noncompliance with their obligation to use "best efforts"—on the ground that appellant's part in these violations did not rise to the level of aiding and abetting.

Appellant is an attorney specializing in corporate law, including securities law, with more than 20 years experience. In June 1971, he was retained by Gerald Bowes, president of Dennison, as special counsel for the purpose of effecting a public offering of Dennison's securities and was given complete responsibility for preparing the issue. In connection with this agreement, appellant thereafter undertook to locate underwriters, to draft necessary documents and to render legal opinions regarding the proposed issue.

These efforts resulted in a public offering in 1972 of 6,000,000 shares at a price of $.10 per share. The underwriters were Carlton and another broker-dealer, Stevens Jackson Seggos, Inc. ("Stevens Jackson"). According to the registration statement for the issue, which the SEC

declared effective on April 26, 1972, the underwriters were to use their "best efforts"[2] to sell the entire offering in 60 days, subject to a possible 30-day extension upon agreement of Dennison and the underwriters. The first 3,000,000 shares were to be sold on an "all-or-none" basis, i.e., if this number should not be sold in the required time, all funds obtained from buyers were to be refunded in full.

Because a refund might become necessary, appellant drafted an escrow agreement—which was made an exhibit to the registration statement and described in the prospectus. It required the underwriters, Carlton and Stephens Jackson, to deposit with the escrow agent, the Bank, "all funds . . . which the Underwriters have received for the purchase of shares of the Stock accompanied by appropriate Letters of Transmittal listing the names and addresses of the purchasers of the Stock and the number of shares purchased by each" within three business days of their receipt. It further provided that the underwriters would set a "Delivery Date" if 3,000,000 shares were sold, at which time the Bank would "deliver to [Dennison] and to the Underwriters, its checks in the amount of $255,000 and $45,000 [the underwriters' commissions on sales of the minimum portion], respectively, *provided that collected funds sufficient to cover such payments shall be in the Escrow Account on the Delivery Date.*" (Emphasis added). Consistent with the foregoing, the agreement explicitly stated that the proceeds of the offering were to be returned to the buyers in full "[i]n the event that there shall not be $300,000 in the Escrow Account on the Delivery Date. . . ."

2 In a "best efforts" underwriting, the underwriter undertakes to sell the offering to the public but assumes no responsibility for any shares not sold. Such an arrangement may be contrasted to a "firm commitment" underwriting, in which the underwriter assumes the risk of loss on the unsold portion of the distribution. Jennings & Marsh, Securities Regulation 75 (3d ed. 1972).

Unfortunately, from the outset Rega and Carlton failed to observe the terms of the offering and took steps to limit sales of Dennison stock in order to enhance their ability to manipulate its price in transactions with their customers. For the purposes of this appeal, we need consider only those three aspects of this scheme that appellant was held to have aided and abetted.

1. *Closing of the "All-or-None" Portion of the Offering*

The escrow agreement contained several provisions designed to assure that purchasers' money would be segregated until it could be definitely determined that 3,000,000 shares of Dennison had been sold. All receipts from sales of the shares were to be deposited immediately, the Bank was to receive detailed lists of purchasers and the quantities of their purchases, and no disbursements were to be made until the account contained $300,000. Unfortunately, as Judge Pierce put it, "this rather simple procedure was not followed."

At the outset, the underwriters were lax in remitting receipts and lists of purchasers to the Bank. Moreover, appellant took the position, despite the express contrary terms of the agreement he had drafted, that the underwriters might deposit funds "net"—i.e., after deducting their commissions. Obviously, these breaches complicated the task of determining how many shares had been sold at any given time.

The parties also deviated from the terms of the escrow agreement by moving to close the "all-or-none" portion of the offering without first taking care to assure that 3,000,000 shares had been sold. Such a closing was first scheduled for May 30, despite the fact that the escrow account contained only some $65,000 at the time. This date

passed without a closing, but new attempts were scheduled for June 5 and then June 12. At no time did the account contain as much as $300,000.

On June 12, the parties gathered at the Bank. The account then stood at $231,003, $7,506.25 of which represented a deposit made by Stevens Jackson, one of the two underwriters, earlier that day. Rega brought with him to this attempted closing a check for $31,493.75 drawn on Carlton's account. Added to the balance in the account, it boosted the balance in the Bank's possession to $262,496.75, less than $300,000 but more than the $255,000 owed to Dennison on sales of the all-or-none portion of the offering. Because appellant had taken the position that the underwriters were entitled to remit funds "net" and that the critical prerequisite to a closing was the presence in the account of sufficient funds to pay Dennison its share of the proceeds of the first 3,000,000 sales, some of those present at the meeting apparently pressed for an immediate closing. However, the Bank refused to disburse any funds until after Rega's $31,000 check had cleared. Moreover, the meeting degenerated into a heated argument over whether the "all-or-none" portion of the offering could legitimately be closed before the escrow account contained $300,000 and without a guarantee that 3,000,000 shares had been sold. Judge Pierce found that no one at this gathering had any clear idea of how many shares had actually been sold. The parties dispersed after the Bank made it clear that it wanted assurances that the "all-or-none" portion of the offering had been sold and that the underwriters had in fact deposited receipts "net" in accordance with appellant's position.

On the following day, June 13, appellant drafted a letter pursuant to the Bank's request representing that 3,075,000 shares had been sold, 351,000 of which were attributed to

Stevens Jackson[3] and the remainder to Carlton. Judge Pierce held that appellant had no informed basis for his categorical statement, and none appears in the record.[4] Indeed, the figure soon proved wrong; only 3,073,500 shares were requisitioned from the stock transfer agent and delivered to the Bank on June 19.

After appellant had written his letter to the Bank containing the 3,075,000 figure, Carlton ordered 2,724,000 shares from the transfer agent; the record reveals no previous *specific* statement as to the volume of its sales. Of the shares ordered, 1,000,145 were requisitioned in Carlton's own name ("street name"). The lower court found that a large number of shares did not actually correspond to sales to customers of Carlton, concluding that Carlton had simply subtracted the number of shares claimed to have been sold by Stevens Jackson from the 3,075,000 figure supplied by appellant. In this way Carlton arrived at the figure it was supposed to have sold. It supplied the difference between this figure and its actual sales by subscribing for the difference in "street name" shares.[5] Accordingly, Judge Pierce concluded that the underwriters had never actually sold 3,000,000 shares.

3 The 351,000-share figure matched a representation in a letter written by Stevens Jackson to the Bank on June 13.

4 Judge Pierce hypothesized that appellant had assumed all along that the minimum closing scheduled for June 12 would cover exactly 3,000,000 shares and merely added 75,000 shares corresponding to Stevens Jackson's deposit of roughly $7,500 on June 12 without ever verifying any actual sales. Appellant mounts a vigorous attack on this suggestion. However, this dispute is peripheral, since appellant has failed to offer any valid affirmative basis for his categorical assurance that 3,075,000 shares had been sold. Whether or not the representation was based on the computation hypothesized by the lower court, it was not based on a reasonable investigation.

5 All of Carlton's records concerning specific transactions that preceded that closing of the "all-or-none" portion of the offering were allegedly transferred to New Jersey, damaged in a flood, and then destroyed prior to the trial of this action.

Nevertheless, on June 20 and 27, the Bank disbursed all of the funds in the escrow account, paying part to itself for its fee, part to Stevens Jackson for unpaid commissions, and the balance to Dennison, the issuer, as its proceeds from the offering. The Bank's conclusion that 3,000,000 shares had been sold was based on its count of the certificates received from the transfer agent, the unsupported representation in appellant's letter of June 13 and communications from the underwriters assuring it that the shortfall in the escrow account was due to their practice of remitting funds "net."

2. *Carlton's Trading During its Participation in the Distribution*

Even before the closing of the minimum portion of the offering, Rega began taking steps to manipulate the price of Dennison shares. On June 1 and 2, he misled a trader at M.S. Wien, a trading house, by informing him that the Dennison issue would be closed as of June 2 and thus open for normal trading on that date. Consequently, M.S. Wien submitted a listing application to the National Quotation Bureau for inclusion in its "pink sheets."[6] The listing, which appeared in the sheets distributed to brokers on June 5, indicated the firm's intention to make a market in the stock by buying and selling its shares.

On June 5, M.S. Wien received a purchase order for 37,000 shares from K.F.M. Securities, which it filled at a price of $.145 a share, thereby taking a short position in the stock. Thirty-five thousand of the shares ordered by K.F.M. represented an order placed by a Carlton employee, Ross Pascall, with K.F.M. Thus, the effect of Rega's mis-

6 The "pink sheets" describe a publication sent to broker-dealers which lists the prices at which dealers are willing to buy and sell over-the-counter stocks.

representations to M.S. Wien and Pascall's order was to create the impression of a public market in Dennison stock at a price above the $.10 offering price at which Carlton was supposed to be making sales to the public.

Judge Pierce credited the testimony of a trader at Stevens Jackson, one Lian, to the effect that appellant, prior to the entry of Dennison in the pink sheets, had notice of M.S. Wien's intention to make a market in Dennison stock. The firm's listing was also called to appellant's attention on a couple of subsequent occasions. However, he did not investigate the circumstances surrounding M.S. Wien's action. He contends now that he assumed that M.S. Wien would be trading on a "when, if, and as issued" basis[7] and saw no need for any inquiry. In this respect his initial response was somewhat similar to that of Steven Glusband, an SEC investigator responsible for monitoring the Dennison offering, who testified that the appearance of M.S. Wien in the pink sheets in and of itself did not establish a violation of the securities laws. However, after a short period of inaction Glusband did initiate an inquiry into M.S. Wien's activities by calling that firm and others.

3. *The Failure to Use Best Efforts*

Judge Pierce found that Carlton made only a limited attempt to sell the Dennison offering, despite the require-

7 Most trading is conducted on the basis of "regular way contracts" which require settlement and delivery of the certificates no later than the fifth business day after the transaction. "When, as and if issued" trading refers to transactions in shares that have not been formally issued, and, accordingly, settlement is contingent on later issuance of the stock. CCH NASD Manual §4, ¶3504.10.

On June 5, when M.S. Wien's listing in the pink sheets first appeared, the formal closing of the "all-or-none" portion of the issue was still more than two weeks off, so regular way trading was not proper. Nevertheless, testimony at trial indicated that M.S. Wien, having been misled by Rega, intended to trade on a regular basis from the outset.

ment of its contract with the issuer and its representation in the registration statement that it would use its "best efforts" to dispose of all 6,000,000 shares. Indeed, Carlton ceased soliciting sales of Dennison at the $.10 offering price secretly on May 29, only a little more than a month after the registration statement had become effective and well before the end of the minimum 60-day selling period.

Appellant was in frequent contact with Carlton both before the June 12 meeting at the Bank and thereafter. However, by his own account, he made no effort to inquire into its efforts to sell the maximum portion of the offering. His explanation at trial was that other matters had kept him too busy to monitor the success of the entire issue.

Eventually, the facts of Carlton's improper trading[8] and its failure to use their "best efforts" came to light. On July 11, an amendment to the registration statement deregistering the offering was filed.

In assessing appellant's responsibility for these improper activities, Judge Pierce applied a standard derived from *SEC* v. *Spectrum Ltd.*, 489 F.2d 535, 541 (2d Cir. 1973), and *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 811 (2d Cir. 1975), cases in which we stated that liability for aiding and abetting could be based on negligent conduct when the defendant "should have been able to conclude that his act was likely to be used in furtherance of illegal activity." 515 F.2d at 811. The district court concluded that appellant's acts and failures to investigate were negligent and assisted those primarily responsible for the improper closing of the escrow account, improper trading in Dennison shares by Carlton and those connected with it, and Carlton's failure to use best efforts. Accord-

8 On June 15 Carlton entered a listing in the pink sheets under its own name.

ingly, the lower court held appellant liable as an aider and abettor of each of these violations.

Discussion

Appellant's principal contention is that Judge Pierce applied an incorrect legal standard in determining his liability as an aider and abettor. Citing the Supreme Court's holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), that "scienter"—i.e., an "intent to deceive, manipulate, or defraud"—must be shown in a private action for damages based on Rule 10b-5, he maintains that he should not have been judged under a negligence standard in this SEC enforcement action for injunctive relief. This calls upon us to determine the standard of liability to be applied in the present case.

In determining the applicable standard, we are governed by several basic principles. First of these is the concept, several times reiterated by the Supreme Court, that the federal securities acts embody liberal notions of fraud and deceit, *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 195, 200 (1963), and that they should be flexibly construed in order to give effect to their broad purposes, *Capital Gains Research Bureau, supra,* 375 U.S. at 195; *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151 (1972); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971); *J.I. Case* v. *Borak,* 377 U.S. 426, 432-33 (1964). Secondly, as the Court pointed out in *Hochfelder,* since Congress has specified differing standards of liability in different sections of the federal securities laws, which vary according to the specific remedial purpose to be served by each section, "[a]scertainment of Congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section," 425

U.S. at 200. Lastly, as we recently held in *Rolf* v. *Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 44-48 (2d Cir. 1978), a reckless disregard for the truth or falsity of a material statement, as distinguished from mere negligence, may constitute scienter or the legal equivalent of knowledge. *See United States* v. *Benjamin,* 328 F.2d 854, 862-63 (2d Cir. 1964), *cert. denied sub nom. Howard* v. *United States,* 377 U.S. 953 (1964).

In *Hochfelder* the sole claim at issue was whether an accounting firm could be held liable in a private action for damages under §10(b) of the 1934 Act and Rule 10b-5, in the absence of any allegation of scienter, i.e., on the basis of its negligence in failing to conduct proper audits of a firm alleged to have defrauded the plaintiffs. The Supreme Court, in holding that allegation and proof of scienter was essential, based its decision on the legislative history and language of §10(b), which makes it unlawful for any person to use or employ, in connection with the purchase or sale of a security, "any manipulative or deceptive device or contrivance" in contravention of such rules and regulations as the Commission may prescribe. Rule 10b-5, promulgated by the Commission purportedly pursuant to its power under §10(b), proscribed without mention of scienter the use in interstate commerce of "(b) . . . any untrue statement of a material fact or [omission of] a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." The Court concluded that the statute's words "manipulative or deceptive," when used in conjunction with "device or contrivance" and viewed in the light of the statute's legislative history, "connote intentional misconduct." 425 U.S. at 197. It further concluded that, although the broader language of Rule 10b-5 could encompass negligent behavior, "its scope cannot ex-

ceed the power granted the Commission by Congress under §10(b)." 425 U.S. at 214.[9] Applying these principles here, the present case differs from *Hochfelder* in at least one important respect.[10] Here the SEC charged appellant not only with a violation of §10(b) of the 1934 Act but also with violation of §17(a) of the 1933 Act, the language of which is significantly different from that of §10(b). Section 17(a) provides:

"(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

9 The Court stated, "Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not." 425 U.S. at 212.

10 We have not yet resolved the question, left open in *Hochfelder*, of whether "scienter" is required in suits brought by the SEC for injunctive relief based on §10(b) or Rule 10b-5. See *SEC* v. *Bausch & Lomb, Inc.*, 565 F.2d 8, 14 (2d Cir. 1977); *SEC* v. *Commonwealth Chemical Securities, Inc.*, No. 76-6175 (2d Cir. March 3, 1978), slip op. at 1852-55. We need not reach it in this case.

This wording is virtually identical to that of Rule 10b-5, which the Supreme Court suggested in *Hochfelder* would subject wrongdoers to liability for negligence were it not for the fact that the rule can be no broader than the statute under which the rule was promulgated. 425 U.S. at 212. As the Court stated, the language of subsection (2) of §17(a) gives no indication that liability is predicated on fraudulent intent. *Id.* Moreover, the clear import of the critical phrase in subsection (3), "operates as a fraud," is to focus attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible.[11] Absent any terminology in §17(a) comparable to "manipulative or deceptive device or contrivance" in §10(b), upon which the Supreme Court relied heavily in *Hochfelder,* we see no reason to give §17(a) a similarly narrow reading.[12]

11 Because of the use of the term "fraud," some have viewed this phrase as entailing a requirement of intent. E.g., *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790, 795 (7th Cir. 1977); 3 Loss, Securities Regulation 1441-42 (2d ed. 1961), as supplemented, 6 Loss, Securities Regulation 3552-53 (Supp. 1969). However, we believe that the phrase read as a whole was intended to expand common law notions of the elements of fraud. Cf. *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963) (discussing Investment Advisers Act of 1940, "Congress in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure. . . .").

12 Since *Hochfelder* other courts have divided on the question of whether the holding in that case should be extended to suits brought under §17(a). Compare *SEC* v. *Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976); *SEC* v. *Shiell* [1977-78 Transfer Binder], Fed. L. Sec. Rep. (CCH) ¶96,190 (N.D. Fla. 1977); *SEC* v. *Southwest Coal & Energy Co.*, 439 F. Supp. 820, 826 (W.D. La. 1977); *SEC* v. *World Radio Mission*, 544 F.2d 535, 541 n.10 (1st Cir. 1976) (no intent to deceive, defraud or manipulate required under §17(a)), with *SEC* v. *American Realty Trust Co.*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977); *SEC* v. *Cenco Inc.*, 436 F. Supp. 193, 199-200 (N.D. Ill. 1977) (scienter required). See also *Collins Securities Corp.* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977) (not reaching the issue).

Our reading of the language of §17(a) is in accord with its legislative history. When legislation to regulate the selling of securities to the public was being considered by both Houses of the Congress in 1933, the Senate passed a bill that included the following provision:

> "Sec. 13. It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly, in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities *willfully* to employ any device, scheme, or artifice or to employ any 'dummy', or to act as any such 'dummy', *with the intent to defraud* or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice, or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser. . . ." (Emphasis added).[13]

However, the House version of the legislation contained no such requirements of willfulness or "intent to defraud." Its approach was ultimately adopted by the Conference Committee.

Congress thus opted for liability without willfulness, intent to defraud, or the like, in enacting §17(a). Indeed, William O. Douglas, who was soon to head the SEC and later to become a Justice of the Supreme Court, wrote contemporaneously that §17 makes unlawful "even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 181 (1933) (footnote omitted).

13 This provision was introduced on the floor of the Senate as §13 of S. 875 (73d Cong., 1st Sess.).

Finally, nothing in the structure of the remedies provided in the securities acts suggests that an intent to deceive, defraud or manipulate is implicit in §17a when it serves as the basis for an SEC enforcement action. Some courts have noted that if a private action for damages were recognized under §17(a), and if scienter were not required, the effect might well be to negate limitations on private recoveries for negligence contained in §§11, 12(2) and 15 of the 1933 Act, 15 U.S.C. §§77k, 77*l*(2), and 77o.[14] Even assuming this to be so,[15] it could not properly provide a basis for limiting the liability Congress apparently intended to create with regard to SEC enforcement proceedings.

Impressive policies support an interpretation of §17(a) enabling the SEC to seek injunctive relief on the basis of negligent conduct. The essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender. E.g., *Capital Gains Research Bureau, supra,* 375 U.S. at 193, 200. This purpose is furthered by an interpretation of §17(a) which enables the SEC to move against negligent conduct whose effects on the public may be every bit as detrimental as those produced by intentional misconduct.

14 E.g., *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790, 795-96 (1st Cir. 1977); *Malik* v. *Universal Resources Corp.*, 425 F. Supp. 350, 363-64 (S.D. Cal. 1976). See 3 Loss, Securities Regulation 1784-87 (2d ed. 1961), as supplemented, 6 Loss, Securities Regulation 3912-15 (Supp. 1969).

15 The questions of whether such an implied private right of action for damages exists under §17(a) and what its elements may be apparently remain open. See *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 734 n.6 (1975); *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 787 (2d Cir. 1951) (dicta); *SEC* v. *Texas Gulf Sulfur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, *J.*, concurring), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969).

Inasmuch as those responsible as principals for violations of §17(a) may be liable for negligent misconduct in the context of SEC enforcement actions, we see no reason why scienter of the sort required in *Hochfelder* should be a necessary element of aiding and abetting. Rather, we adhere to the flexible standard we articulated in *SEC* v. *Management Dynamics, Inc., supra.* The test is whether an alleged aider and abettor "should have been able to conclude that his act was likely to be used in furtherance of illegal activity," in light of all of the circumstances, 515 F.2d at 811, including the nature of the defendant's assistance to the primary wrongdoer, his participation in the challenged conduct, his awareness of the illegal scheme, and any duties to investigate or supervise that may be applicable. As we recognized in *SEC* v. *Spectrum, Ltd., supra,* this flexible standard may sometimes impose stringent obligations upon attorneys whose actions facilitate wrongdoing. We stated there:

> "We do not believe, moreover, that imposition of a negligence standard with respect to the conduct of a secondary participant [an attorney] is overly strict, at least in the context of this case. The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters." 489 F.2d at 541-42.

Accordingly, in assessing appellant's conduct on the basis of principles developed in *Spectrum* and *Management Dynamics,* Judge Pierce was applying standards appropriate

to §17(a). Moreover, if appellant acted with reckless disregard for the truth or falsity of material misrepresentations made by him, his conduct would also violate §10(b) of the 1934 Act, according to the interpretation of that section adopted by us in *Rolf* v. *Blyth, Eastman Dillon & Co., supra.* We turn, therefore, to the question of whether application of these standards to the present case would require any change in the conclusions reached by the district court.

With regard to the closing of the minimum "all-or-none" portion of the issue, appellant's misconduct clearly aided and abetted a violation of §17(a). The failure to comply with the terms of the escrow agreement and the closing prior to the bona fide sale of 3,000,000 shares[16] plainly "operated as a fraud" upon the public. The lower court's finding that 3,000,000 shares had not been sold in genuine transactions was not clearly erroneous. On the contrary, it is supported by ample evidence, including the non-existence of $300,000 in the escrow account, Carlton's order for the exact number of "street name" shares required to match the difference between Stevens Jackson's claimed sales of 351,000 shares and the figure of 3,075,000 shares apparently picked by appellant out of the air, and the mysterious destruction of the records of Carlton's sales. Even if the

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16 See *SEC* v. *Commonwealth Chemical Securities, Inc.*, No. 76-6175 (2d Cir. March 3, 1978), slip op. at 1845; Securities Exchange Act Release No. 11532, July 11, 1975, 2 Fed. Sec. L. Rep. (CCH) ¶22,730 (July 29, 1975):

> "[U]nder Rule 10b-9, an offering may not be considered 'sold' for the purposes of the representation 'all or none' unless all the securities required to be placed are sold in *bona fide* transactions and are *fully paid for.* It is clearly contrary to the intent and purpose of the rule to declare an offering all sold, for the purposes of the 'all or none' conditions . . . on the basis of non-bona fide sales designed to create the appearance of a successful completion of the offering, such as purchases by the issuer through nominee accounts." (Emphasis added).

underwriting agreement provided that Carlton might purchase Dennison shares for its own account (for resale to the public at the offering price), ¶3(f); 697a, it obviously did not contemplate that the underwriter would be able to make purchases at less than the offering price by depositing funds net of commissions in the escrow account. *SEC* v. *Commonwealth Chemical Securities, Inc.*, No. 76-6175 (2d Cir. March 3, 1978, slip op. at 1845).[17] Accordingly, it is not a defense, as appellant suggests, that Dennison itself received funds corresponding to the amount it would have received net from sale of 3,000,000 shares or that certificates representing 3,073,500 shares were issued.

Appellant's own suggestion that the underwriters could deposit receipts net of commissions in the escrow account, moreover, destroyed the simple means devised by the parties for determining whether 3,000,000 shares had in

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17 Rule 15c2-4, 17 C.F.R. §240.15c2-4, which was promulgated pursuant to authority granted in §15(c)(2) of the 1934 Act is instructive. It provides in part:

> "It shall constitute a 'fraudulent, deceptive, or manipulative act or practice' as used in section 15(c)(2) of the Act, for any broker, dealer or municipal securities dealer participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:
>
> * * * * * *
>
> "(b) If the distribution is being made on an 'all-or-none' basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred."

fact been sold and jeopardized the purchasers' right to receive a full refund in the event that the minimum portion of the offering should be unsuccessful. After the June 12 meeting, which clearly put appellant on notice that a question existed as to whether 3,000,000 shares had been sold, he promptly wrote a letter falsely stating that 3,075,000 shares had been purchased without having any basis for this representation. This action not only was negligent for purposes of §17(a), but also amounted to the kind of "reckless disregard" we have recently held sufficient to support a finding of scienter in a private damage action under §10(b) of the 1934 Act. *Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 44-47. Since this letter was prepared at the request of the Bank in order to assure that the minimum portion of the offering would not be closed improperly prior to sales of a sufficient number of shares, appellant clearly "should have been able to conclude" that his letter was "likely to be used in furtherance of illegal activity." In this respect, appellant's conduct is substantially the same as that of the attorney in *Spectrum, supra,* who prepared an opinion letter incorrectly stating that unregistered stock could be traded, which was then used to facilitate illegal sales of the stock. In short, appellant not only failed to take even the first step to guarantee compliance with the terms of the escrow agreement and registration statement that he had drafted, but also assisted Rega and Carlton in obtaining a closing of the minimum portion of the offering on the basis of sales that were not bona fide. Under the circumstances, he can not now claim that he would have been unable to uncover Carlton's wrongdoing even if he had tried.

Appellant's liability for Carlton's improper trading activity and for the underwriters' failure to use their "best efforts" to sell the maximum portion of the Dennison offer-

ing is more troublesome. His participation in these matters was limited to a failure to investigate and disclose the underwriters' activities to the public, to Dennison, or presumably to the SEC. Although the circumstances may well have prompted a reasonable person to investigate, we cannot conclude that appellant should have known that his failure "was likely to be used in furtherance of illegal activity." Under the circumstances, therefore, the lower court's findings are insufficient, under the *Management Dynamics* standard, to hold appellant liable for aiding and abetting the failure to use best efforts and Carlton's improper trading.

With regard to appellant's failure to investigate the appearance of M.S. Wien in the pink sheets, there can be no doubt that Rega, Carlton's president, and Pascall, its employee, violated Rule 10b-6 and §17(a). Rega's misleading statements induced M.S. Wien to begin trading in Dennison, and Pascall placed an order, later reflected in the pink sheets, that created a false indication of public interest in the stock. Nevertheless, as the SEC's investigator testified, the appearance of M.S. Wien in the pink sheets—a circumstance of which appellant had prior notice—was not in itself indicative of illegality, since it was consistent with trading on an "if, as and when issued" basis. Although, as the SEC points out, even this kind of trading may be deceptive if induced by an underwriter, the lower court did not find that appellant was aware of Carlton's role in M.S. Wien's activities. Absent some concrete indication of knowledge by appellant that an underwriter was engaged in wrongful trading, we do not think that as attorney for the issuer he was under an obligation to investigate trading in the issuer's securities to determine whether an underwriter was so engaged. Accordingly, under the circumstances of this case, we conlude that

appellant's failure to investigate M.S. Wien's market-making role did not aid and abet the unlawful trading that took place through that firm.

Likewise we hold that appellant's failure to uncover the underwriters' failure to use "best efforts" did not constitute aiding and abetting of a violation of the securities laws. We may assume *arguendo* that the underwriters' conduct "operated as a fraud" on the public and thereby violated §17(a). Obviously, it was important to the public that the underwriters comply with this part of their contract with Dennison, which was incorporated in Dennison's registration statement, since the company's future prospects and the nature of the market for subscribers' shares were dependent on the volume of the underwriters' sales. However, although the lower court found that after June 12 appellant took no action to monitor the progress of the underwriters' effort to sell the maximum portion of the offering, it was not shown that appellant actually knew that Carlton had secretly stopped selling at an early point in the offering, or that he had any stake in limiting the public distribution, as did Carlton. While we think that appellant showed bad judgment in failing to make the minimal inquiries of the underwriters' attorney—particularly in view of the confusion surrounding sales of the minimum portion —we cannot conclude that he "should have known" that his inaction would further illegal activity. The full scope of Carlton's failure to comply with the terms of its undertaking to attempt to sell Dennison's shares was not revealed, according to Judge Pierce's findings, until shortly before the deregistration of the issue, and even the turmoil surrounding the closing of the minimum portion of the offering did not furnish the basis for an assumption that Carlton had undertaken to subvert completely the legitimate goals of the issue. Under the circumstances, we do

not find a sufficient factual basis for the conclusion that appellant aided and abetted the underwriters' misconduct.

Because the lower court erred in holding that appellant aided and abetted Carlton's improper trading and the failure to use best efforts to sell the maximum portion of the issue, those portions of its final order enjoining appellant from committing future violations of the same kind must be reversed. *SEC* v. *Commonwealth Chemical Securities, Inc.*, No. 76-6175 (2d Cir. March 3, 1978), slip op. at 1851; *SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1102 (2d Cir. 1972).[18]

In all other respects we affirm the judgment of the lower court.

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18 Appellant has also maintained that injunctive relief should not have been granted against him because of an insufficient showing of a likelihood of future violations. Although the lower court's first opinion improperly stated that appellant had the "burden" of showing that his past violations would not be repeated, see *SCM Corp.* v. *FTC*, 565 F.2d 807, 812-13 (2d Cir. 1977), his second opinion canvassed the relevant factors bearing on the possibility of future violations without regard to the burden of proof. He was well within his discretion in enjoining appellant from committing future violations of the same sort in which he participated during the Dennison offering. See *SEC* v. *Manor Nursing Centers, Inc.*, *supra*, 458 F.2d at 1100-03.

ORDER OF COURT OF APPEALS DATED 8-7-78

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventh day of August, one thousand nine hundred and seventy-eight.

PRESENT:
HON. LEONARD P. MOORE
HON. J. JOSEPH SMITH
HON. WALTER R. MANSFIELD
Circuit Judges

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

-vs.-

BERNARD JAY COVEN,

Defendant-Appellant.

A petition for a rehearing having been filed herein by counsel for the defendant-appellant, upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

s/A. Daniel Fusaro
A. Daniel Fusaro
Clerk

ORDER OF COURT OF APPEALS
DATED AUGUST 7, 1978

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventh day of August, one thousand nine hundred and seventy-eight.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

vs.

BERNARD JAY COVEN,

Defendant-Appellant.

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the defendant-appellant, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

s/Irving R. Kaufman
Irving R. Kaufman
Chief Judge

APPENDIX "C"
OPINION
ENTERED JUNE 30, 1975

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-v-

JOSEPH REGA, JR., et al.,

Defendants.

LAWRENCE W. PIERCE, D.J.

OPINION

This is an action for injunctive relief in which the Securities and Exchange Commission (Comission) has charged the defendants with various violations of the Securities Act of 1933, 15 U.S.C. §77a(a) et seq., as amended, and the Securities Exchange Act of 1934, 15 U.S.C. §78(a) et seq., as amended, and rules promulgated thereunder. A trial was held on this matter at the conclusion of which the Court reserved decision. Having found that it has jurisdiction[1] over the parties and subject matter of this action the Court makes the following findings of fact and conclusions of law pursuant to Rule 52(a) of the Fed. R. Civ. P.

On April 26, 1972 the Commission declared effective a registration statement with respect to the public offering of the common stock of Dennison Personnel, Inc. (Dennison). The

listed underwriters for this offering were defendant Carlton-Cambridge & Co., Inc. (Carlton), a New Jersey broker-dealer of which defendant Joseph Rega, Jr. was President and Chief Executive Officer and Stevens Jackson Seggos, Inc. (Stevens Jackson), another broker-dealer. Defendant Bernard Jay Coven acted as counsel for the issuer and defendant Robert B. Levin served as counsel to the underwriters.[2] The remaining individual defendants were employees of Carlton. Defendant Ross W. Pascall was the resident manager of the West Caldwell office of Carlton and defendant Louis Levine acted in a similar capacity at Carlton's Fort Lee office. Levine was also a registered representative. The other three individual defendants—Bernard A. Colloff, Joseph Corvino and Harold Weinberg—were employed by Carlton as registered representatives. Also named as defendant is Christian-Paine & Co., Inc. (Christian), the Commission having claimed that Christian is merely the "successor" of Carlton. Defendant Republic National Bank of New York (Republic) acted as escrow agent for the receipt of subscribers' funds in connection with the offering.

Under the terms of the Dennison public offering, as expressed in the registration statement and in the prospectus which was disseminated to members of the investing public, a total of 6,000,000 shares of Dennison stock was to be offered at $.10 per share. The underwriters represented that they would use their best efforts to sell the entire offering on a "3,000,000 shares or none" basis. This meant that if at least 3,000,000 shares were not sold within the maximum ninety day[3] selling period, all funds received from public subscribers would be promptly refunded without interest. Pending the sale of the minimum amount of shares, subscribers' funds were required to be deposited in an escrow account maintained with the defendant Republic pursuant to an escrow agreement. More precisely the escrow agreement (Section 1) provided that the underwriters were to deposit with, or to mail for deposit to, the escrow agent not later than the third business day following the receipt of the same, all funds which the underwriters had received for the purchase of shares of Dennison stock accompanied by appropriate letters of transmittal listing the names and addresses of the purchaser of the stock and the number of shares purchased by each. At such time as the minimum number of shares (3,000,000) had been sold a "minimum closing" would take place. It was expected that the fact that the minimum had been sold would be established when the underwriters deposited with the bank $300,000 reflecting the sale of 3 million shares at .10¢ per share. At that point the bank was to remit to the issuer $255,000 and the balance would be turned over to the underwriters to cover their commissions and expenses. After the minimum closing had taken place the underwriters were committed to use their "best efforts" during the remainder of the selling period to sell as many of the remaining balance of the offering as they possibly could. Unhappily this rather simple procedure was not followed and from the very outset the offering was marred by a number of irregularities.

Initially Carlton through Rega apparently decided to limit its efforts to a sale of the minimum portion of the offering despite the language in the registration statement and prospectus which assured the investing public that "best efforts" would be made to sell the entire issue of 6,000,000 shares for the benefit of Dennison. Thus Rega established an allotment system which provided each of the branch offices of Carlton with a maximum number of shares for distribution by its salesmen. These allotments totalled, in the aggregate, approximately 3,000,000 shares or, in other words, the minimum number of shares which could be sold without having to refund monies collected from subscribers. With respect to the other underwriter, Stevens Jackson, the Commission has claimed that Stevens Jackson had no intention of selling any shares of the issue at all. The Commission alleges that Stevens Jackson through its principal, Elephtherios P. Seggos, had an arrangement with Coven whereby it would appear as underwriter as an "accommodation." The actual sale, it is charged, would be undertaken by one of Coven's employees and Stevens Jackson would merely send out confirmations of purchases and collect the money. The evidence adduced at the trial failed to support this allegation with respect to the Dennison offering. In fact, it is uncontroverted that Stevens Jackson did sell 80,000 of the shares. In

addition, a selling group did materialize—per-haps fortuitously—under the apparent aegis of Stevens Jackson. This selling group managed to sell an additional 266,000 shares. However, it appears that Seggos personally had no intention of selling any of the shares. In fact Seggos was out of the country during most of the selling period. To that extent the clear implication in the prospectus that Seggos would be personally involved in the sales effort was erroneous. Also it would appear that the representation in the registration statement and prospectus that best efforts would be used to sell the entire issue was false. No principal from Stevens Jackson ever indicated that it would engage in such efforts. At most the evidence indicates that Stevens Jackson's one and only salesman, Ziffer, would attempt to sell *some* of the shares. As noted, Carlton only intended to sell at most one-half of the offering. Thus, from the outset, serious undisclosed limitations were imposed on the handling of the offering.

The Sale of the Original Issue

The sales effort by Carlton's salesmen was riddled with irregularities. Salesmen recommended the stock to customers of the firm without having made an effort to determine that such an investment was suitable for the particular customer concerned. Also they failed to bring to their customer's attention material facts in connection with the purchases of Dennison shares by such customers. In sh ort, there was a high-powered concentrated drive to dispose of the alloted shares regardless of the particular circumstances relating to each sale. A few examples will suffice. Defendant Levine sold 1,000 shares of the stock to a student-based on a "cold-call"—without making any meaningful inquiry into the stock's suitability for that particular person. In making this sale he neglected to mention that the stock was speculative or that Dennison had a large working capital deficit. Defendant Colloff also sold the stock without disclosing Dennison's financial condition. In addition he "touted" the stock to two of his customers predicting that its price would rise without having any valid basis whatsoever for

such an opinion. Defendant Corvino engaged in similar practices in selling the Dennison issue. He did not investigate the stock's suitability to a particular customer, failed to disclose Dennison's financial status and engaged in price projections. Defendant Weinberg persuaded a customer to buy 1,000 shares of Dennison without making any efforts to determine suitability. In so doing he also predicted—without any valid basis—that the stock would go up to .50¢. To another customer he indicated that the price of the stock would triple in a few months.

While this somewhat dubious sales effort was progressing, there was at least some semblance of compliance on the part of Carlton through its president, Rega, with regard to some of the provisions of the escrow agreement. On May 19, 1972 Republic received from Carlton its first deposit for the escrow account in the amount of $27,320 representing the gross funds from the sale of 273,200 shares of Dennison stock together with a covering letter and confirmations for such sales. Three days later—on May 22, 1972—Carlton made a second deposit of $21,650 evidencing the sale of 216,500 shares of the stock. The deposit was again accompanied by a covering letter and the respective confirmations of the sales. Carlton made no further deposits into the escrow account until June 7, 1972.

It should be noted that as funds relating to sales of the shares were being received by Carlton, they were deposited into a Carlton business checking account at Commercial Trust Co. of New Jersey and later Carlton wrote checks against this account for deposit in the escrow account at Republic. These funds were not segregated in any way and it may well have been that the funds were spent by Carlton in the ordinary course of business.

On May 29, 1972, weeks before the cut-off date, Rega unilaterally decided to stop soliciting purchases at the .10¢ offering price on the pretext that sales had peaked and the issue had become "stale." Apparently by this time Rega had decided that it would be sufficient to comply with the conditions of the offering if the indications of interest it had received combined with the indications received by the Stevens Jackson group totalled over 3,000,000 shares. Once this number of indications had

been reached, efforts to sell the original issue by both underwriters ceased. By this time Carlton had received indications for 2,760,000 shares of Dennison stock and Stevens Jackson was claiming 350,000 indications for a total of 3,110,000 shares sold or indicated for. It should be noted that these "indications of interest" were just that and did not represent actual sales since the prospective purchasers had the right to cancel them. Therefore, it is not at all established that by May 29, 1972 even the *minimum* portion of the offering had in fact been sold. Indeed by that time there was on deposit in the escrow account at Republic only $48,970 representing the two deposits made by Carlton. Nevertheless, preparations were confidently made for a May 30, 1972 closing. For example, Coven, having been told that Carlton had sold more than the minimum portion of the offering prepared an opinion letter dated May 30, 1972 as one of the required closing documents pursuant to ¶6.06 of the Underwriting Agreement. However, the closing was adjourned to June 5, 1972 and on that date had to be postponed again. The scheduled closings were apparently called off because there were insufficient funds in the escrow account. Another closing was scheduled for June 12, 1972.

Even before the minimum closing had actually taken place the manipulation of the Dennison stock price began. On June 1, 1972 Rega and Preston Morris—a trader specializing in over-the-counter stocks at M.S. Wien, a trading house—had a telephone conversation. Rega told Morris that the Dennison issue was about to close. On that date, Morris submitted a listing application in name only in the "pink sheets."[4] This meant M.S. Wien would be a market-maker. However, before he traded the stock Morris wanted to be sure it had closed so he again spoke with Rega on June 2 who told him the issue had closed and was free for trading. On that basis M.S. Wien commenced making a market on trade date June 5, the day the June 2 "pink sheets" were disseminated to brokers. The market M.S. Wien was making was a regular market as opposed to a "when-issued" market. Morris' first transaction was a purchase order received from K.F.M. Securities for 37,000 shares which Morris filled at .145¢. This left M.S. Wien "short" 37,000 shares and

set the market at .10 bid—.14 ask. The June 5 order from K.F.M. Securities consisted in large part of an order placed by Ross Pascall—Carlton's resident manager of the West Caldwell office. On June 5 Pascall ordered 35,000 shares through an account in his name at K.F.M. Securities. The Pascall transaction "pegged" the market as .10¢-.14¢, a 40% premium over the new issue price.

It is also clear that Coven knew before hand that M.S. Wien was going to appear in the "pink-sheets." There was credible testimony that prior to that appearance Coven had called a trader at Stevens Jackson and indicated to him that M.S. Wien would be making a market in the sheets for Dennison and that it would appear on June 1 or 2. Subsequently when Coven was specifically "informed" that M.S. Wien was in the sheets, he blithely assumed that M.S. Wien was trading on a "when issued" basis.

Also on June 2—again before a minimum closing had taken place—salesmen of Carlton began to solicit purchases of Dennison at prices in excess of the offering price. On that date, the first day of trading, Carlton sold 120,500 shares of Dennison stock for its own account to public customers even though, a few days earlier, Rega had concluded that the issue was "stale." Of the 120,500 shares sold, 100,000 shares were sold at .11¢ per share and 20,500 shares were sold at .13¢ per share. Between June 2 and June 20, 1972, Carlton, as principal, sold to its customers approximately 380,000 shares of Dennison stock at prices in excess of .10¢ per share.

The District Court found that the principal defendant whom the petitioner was found to have aided and abetted had violated Rule 10b-9. How one could aid and abet a §17(a) viola-

The minimum closing had been rescheduled for June 12, 1972. On that date there was a "gathering" of all the concerned individuals at the offices of the Republic National Bank. This "gathering" proved to be a somewhat confusing and tangled affair.

A few days prior to this "gathering'—June 9—the escrow account reflected deposits totalling $223,496.75. Coven had adopted the position that if $255,000 was in the account there

could be a closing since this represented Dennison's funds and once that amount was reached the issue could close. Consonant with this position it was Coven's view that the underwriters could transmit "net funds," that is, the difference between the subscribers' funds and the underwriters' commission and expense. On June 12 Rega arrived at Republic with an uncertified check for $31,493.75 representing its last deposit to the escrow account. This was a net check Carlton allegedly having deducted its commission in advance. In addition, on the same date, another check was presented in the amount of $7,506.25 by Stevens Jackson. Both these checks when added to the outstanding balance in the escrow account would raise the escrow account figure to $262,496.75 enough for a closing if the minimum required was $255,000. However, there was a problem in that the Rega check was uncertified. Under these circumstances, Republic refused to disburse the funds in the escrow account. Moreover, the bank wanted some assurances that the minimum number of shares had in fact been sold. It also wanted letters from the underwriters and the issuer noting the commissions deducted in advance. In light of these difficulties, Coven suggested a closing in escrow, i.e., preparation of the papers for a closing pending counting of the certificates by the bank. The "gathering" dispersed with no monies being disbursed from the escrow account and no certificates being distributed.

Pursuant to the bank's request Coven prepared a letter dated June 13, and received on June 15 by Republic indicating that 3,075,000 shares had been sold. It is not at all clear how Coven managed to reach this particular figure. It may be that Coven assumed that the $7,506.25 check presented to the bank on June 12 by Stevens Jackson constituted payment for approximately 75,000 shares and that this amount added to the number of shares then "sold" would bring the total to 3,075,000 shares. Be that as it may, it soon appeared that Coven was in fact mistaken in his estimate of the number of shares sold.

In the meantime a letter was prepared at Carlton pursuant to Rega's instructions directing the transfer agent as to how

many certificates to issue for Carlton's alleged sales. Judging from the figures submitted it would appear that Rega posited as a predicate that 3,075,000 shares were in fact sold as represented by Coven. Therefore, the number of shares to be issued at Rega's instructions added to the number of shares sold by Stevens Jackson would have to total this magic figure. By June 12, 1972 Carlton had purchases of 1,723,855 shares by customers in whose name certificates were to be registered. In addition Stevens Jackson had represented that it had sold 351,000 shares. This brought the total number of shares to 2,074,000 shares allegedly sold. To reach the goal of 3,075,000, Carlton simply instructed the transfer agent to issue 1,000,145 shares in "street name."

Republic received the certificates on June 19, 1972. The certificates were counted by the bank to make sure that at least 3 million were delivered. A count of the certificates demonstrated that the 3,075,000 share estimate was erroneous. Carlton had indicated that it was to receive 2,724,000 shares. Instead, Carlton received 2,727,000 shares. Stevens Jackson had indicated it had sold 351,000 shares. However, Stevens Jackson and its selling group received a total of 346,000 shares. The final number of shares issued totalled 3,073,500 shares, 1,500 shares less than requested by the underwriters. Nevertheless, the count of the certificates plus the letters from Stevens Jackson, Rega and Coven satisfied the bank that the minimum was sold. By June 27, 1972 all the funds in the escrow account had been disbursed by Republic and the account was closed.

The "maxi" portion of the offering was still outstanding and presumably the underwriters were supposed to use their best efforts to sell the remaining shares. But as noted both listed underwriters had stopped selling the issue as of May 29, 1972.[3] From June 12, 1972 to June 30, 1972 Coven made no efforts whatsoever to ascertain whether the "maxi" portion of the offering was being sold. He failed to ask counsel for the underwriters how the sale of the maximum was progressing because he thought Levin was busy with other matters and in addition he, himself, was busy with another issue. Despite the fact that he spoke with Rega on some occasions during this time he

neglected to inquire as to the development of the "maxi" sale since there were more important matters to discuss. It was not until June 29, 1972 that Coven supposedly learned that Carlton was trading the issue. Shortly thereafter Coven learned from Rega that Carlton was not engaged in best efforts to sell the remaining shares. He was also told by Rega that the SEC had been making inquiries with respect to the sale of the Dennison stock. After having subsequently informed the president of Dennison that the issue had to be deregistered,[6] arrangements were finally made to have a deregistration statement mailed to the Commission on July 17, 1972. The amendment deregistering the remaining shares of Dennison was received by the Commission on July 18, 1972.

The After-Market

Carlton had begun selling Dennison shares for its own account on June 2, 1973. During the same time it had induced M.S. Wien to appear in the "pink sheets" and fill an order mainly brought about by Pascall, one of Carlton's resident managers. The evidence is clear that Carlton through Rega contrived to create an artificial market for the Dennison issue. This scheme was greatly facilitated by the fact that the greater part of the Dennison certificates were in the hands of Carlton customers. A prime technique used to control the Dennison after-market was the requirement by Carlton that its salesmen maintain an "orderly market." All salesmen were told by Rega and Pascall of this firm-wide practice. This meant that if a customer sold Dennison the salesman was responsible for finding another customer to buy the shares. If a salesman did not "maintain an orderly market" and the situation became extreme, he would be reprimanded or otherwise disciplined for his failure to keep Dennison stock away from the market. In this fashion the price of the Dennison stock was never exposed to the vagaries of a free and competitive market. By June 21, 1972 Carlton—having created a demand for the stock among its customers—had sold "short" for its own account 340,750 Dennison shares or over 10% of the public offering. This meant, of

course, that Carlton would eventually have to cover its short position by buying the shares from its customers or in the market. Carlton covered its short position in June and July almost entirely by purchasing shares from its customers. Only some 8,000-10,000 shares were purchased outside of Carlton in covering the firm's large short position. In July 1972 by covering its short position and dealing with customers at prices Rega set, Carlton made a gross profit of $10,000. In the following month of August Carlton had only five transactions in Dennison stock with persons outside of Carlton. During that month, dealing almost exclusively with its own customers at prices set and maintained by Rega, Carlton showed a gross profit of $14,000.

The evidence is also clear that in manipulating the Dennison market a number of material misrepresentations and omissions were made to Carlton customers. For example, Carlton did not tell its customers that it was acting as principal in the transaction, that after June 15, 1972 Carlton was making a market in the stock of Dennison or that original issue shares remained unsold and were available at a lower price than that being quoted to such customers by Carlton. Also the firm sold as principal to customers at prices above the prevailing market price without disclosing this fact. The prices charged the customers were in excess of the price in the market and the price at which Carlton was able to buy the stock.

Again, as with the sale of the original issue, defendants Levine, Colloff, Corvino and Weinberg participated in the after-market sales without giving any thought to the interests of their customers. They recommended and sold the stock to their customers without disclosing that Carlton was making a market in Dennison and was selling on a principal basis and without making any effort to obtain the stock at the lowest possible price for their customers.

Christian-Paine

By late June 1972 Rega was aware that the Commission had begun a general inquiry into the Dennison offering. In

September 1972 Rega set in operation his plan to disassociate himself from Carlton and bring into being Christian-Paine. As a first step, on September 15, 1972, he purchased all of the issued and outstanding stock of Continental Planning Corporation, an inactive New York broker-dealer. On October 13, 1972 a Restated Certificate of Incorporation of Continental was filed with the Secretary of State of the State of New York pursuant to which that corporation's name was changed to "Christian-Paine & Co., Inc.". Subsequent to the purchase of the Continental stock and the filing of the Restated Certificate of Incorporation, Rega redeemed all of his voting stock in Carlton-Cambrige and resigned as president of Carlton, leaving Carlton's cashier—Santorriello—as the sole registered principal and president of Carlton. At this time Santorriello had no intention of running Carlton as a retail operation. For the redemption of the stock Rega received $150,000 based upon his original investment in the company. Then on November 15, 1972 an agreement was entered into between Christian-Paine and Carlton under which Christian-Paine purchased some of the assets of Carlton—including all of the Carlton customer accounts' names and addresses. At a meeting of all the registered representatives, Pascal stated that Christian was taking over all of the desirable assets of Carlton. Not knowing what was going to happen to Carlton, the salesmen all transferred to Christian. Christian arranged to conduct its business from the same premises previously used by Carlton. So that the sales men left Carlton one day and returned to their offices the following business day to work as salesmen for Christian with their responsibilities remaining the same at Christian as they were at Carlton.

Instructions were given to the registered representatives to transfer their accounts to Christian and to dispose of everything that had the name Carlton. The current balance in the account of each customer was recorded in the new records set up for Christian but no dates prior to the establishment of the new company were reflected. The old customer books were put in storage[7] and no records showing the name of Carlton were left in the office.

A letter was sent to all customers of Carlton informing them that Christian-Paine had acquired certain assets of Carlton, as well as customer accounts, branch offices records and employees. The letter stated that Christian intended to provide "continuity of services" and asked the customer, "in order to have the acquisition as complete as possible," to sign an authorization to transfer the account to Christian. The end result was that the overwhelming majority of Carlton customers switched over to Christian.

Following this transfer of assets Carlton was left with no branch offices and only one employee, and its securities business was limited to some 10 or 20 transactions per month.

An analysis of the available documentary evidence concerning the financial condition of Carlton before and after the transfer discloses that as of October 31, 1972 Carlton had current assets of $1,347,227, and current liabilities of $389,904. Other liabilities amounted to $661,161. Under the terms of the Carlton-Christian agreement, Christian purchased $671,393 of the current assets and assumed $371,890 of the current liabilities and $310,250 of the "other liabilities." Thus immediately after the agreement was consummated the financial picture was as follows:

	Carlton (10/31/72)	Christian	Carlton Remainder
Current Assets	1,347,224	671,393	675,831
Current Liabilities	389,904	371,890	18,104
Other Liabilities	661,161	310,250	350,911

By December 31, 1972, Carlton's listed assets had dipped to $140,163.70 reflecting a decrease over a period of approximately 1½ months of $535,667.20. By that time also Carlton had no liabilities. So that it would appear that within a period of two months Carlton which purportedly once was one of the largest over-the-counter firms on the East Coast was reduced to a firm with minimal assets, one employee (who was in fact working for Christian), and 12 or 20 transactions per month.

Manipulation by Rega At Christian-Paine

By the late fall of 1972 Rega, now at Christian, instructed his former Carlton salesmen to commence purchasing Dennison from their customers at .12¢ per share. Rega set the market at .12 bid—.15 ask during the period of January to May 1973. The sales campaign initiated by Rega resulted in Christian having by May 1, 1973 an inventory position of 472,115 shares long valued at the acquisition price of .12¢ per share. In the latter part of May the price of Dennison began to rise and by the end of May the price ranged between .17 bid and .20 ask. In early June, Rega prepared an "informational report" on Dennison which was distributed to the salesmen for mailing to customers. This informational report recommended that customers buy Dennison but did not disclose that Christian would be selling out its large inventory position acquired at prices favorable to the firm. In addition, the salesmen at Christian apparently embarked on an intensive sales campaign. The evidence at the trial revealed that most of the sales to customers during June of 1973 were solicited transactions.

During the month of June the price at which Christian through Rega was selling Dennison to its customers rose markedly. On June 12, 1973 Christian was selling Dennison to its customers at .22 bid-.25 ask per share. On the next day the price had risen to .375 bid—.50 ask per share. By June 15, 1973 the price had gone up to .75¢ ask. This was the prevailing price charged until July 5, 1973. During the same period the market price as quoted in the "pink sheets" for Dennison was significantly lower than the price Christian was charging its customers in principal transactions. In fact during this period, the Christian trading account was able to purchase Dennison stock from other brokers in inter-dealer transactions at prices well below the prices Christian charged its customers. For example, from June 15 to June 22, 1973 while Christian was charging .75¢ for Dennison it was able to purchase it from other brokers at prices ranging from a low of .25¢ to a high of .50¢. At the same time the highest market "ask price" in the "pink sheets"

ranged from .50¢ to .625¢. No explanation was given during the trial for such disparate prices nor was any credible explanation given as to reasons why Christian customers were being charged .75¢ per share. In fact there was no justification in the operations of Dennison for the large price increase.

In addition, during the period of May 25 to July 1973, Christian engaged in a great volume of cross-trading between its customers with the firm dealing as principal with each customer and with a large mark-up between purchases from customers and subsequent sales to others. From June 8 to June 11, the firm mark-up on these cross-trades was 25%. During the period from June 12 to June 14 as the price fluctuated upward on the buy and sell side, the mark-up averaged between 20% and 40%. From June 15 to July 5 the firm trading account extracted a mark-up of 20%.

During this period the four salesmen—though they had not done any research into Dennison and therefore knew little if anything of the company's affairs which would serve to give some basis to their recommendations to their customers with respect to the Dennison stock—closely followed Rega's lead. Thus when Rega having set the bid price at .12¢ decided to start acquiring a long inventory position in Dennison, the salesmen followed suit. Levine, for example, purchased 33,000 shares from his customers at .12¢ per share during the months of February, March, April and up to May 25, 1973. During the same period Colloff bought 4,000 shares at the same price. Corvino was doing likewise and Weinberg managed to buy 7,000 shares at .12¢.

When Rega decided to "unload" the shares and engaged in cross-trading between customers at excessive mark-ups, the salesmen—again ignoring their customers' interests—proceeded to effectuate the plan. Thus, during the period from May 25, to July 5, 1973—customers of Levine purchased 60,142 shares at prices ranging from .18¢per share on May 25 to .75¢ per share from June 8 to July 5. At the same time Levine was purchasing from his customers 67,800 shares at prices ranging from.16¢ per share on June 1 to .625¢ from June 11 to July 5. In the meantime, early in June, Colloff had received some inkling that Rega

was going to raise the price of Denison without any justification. As a matter of fact he was under the impression that Rega was going to "boost" the price of Dennison to $1.00 per share. Colloff had no information justifying such an increase. Nevertheless, he proceeded to solicit purchases on the "technical" basis that the price was going up. During the period from June 1 to July 5, 1973 Colloff sold to his customers 27,400 shares at prices ranging from .20¢ per share on June 1 to .75¢ per share from June 8 to July 5. During the same period he bought 20,500 shares from his customers in principal transactions at prices ranging from .375¢ on June 6 to .625¢ from June 8 to July 5. Corvino, for his part, during the period from May 22 to July 5, 1973 sold 36,500 shares to his customers and purchased from his customers 21,500 shares. Finally, Weinberg sold 19,600 shares from May 22 to July 5, 1973. During the same period Weinberg bought 24,900 shares from his customers at prices ranging from .16¢ per share on June 5 to .625¢ from June 8 to June 12.

On May 1, 1973 Christian's balance forward (inventory) position was just over 472,000 Dennison shares. As a result of the extensive trading of the stock beginning in late May and throughout June, Christian's balance forward position on July 1, 1973 was 51,000 shares indicating that in May and June 1973 Christian sold at least 420,000 shares out of inventory to customers in principal transactions. As a result, in June 1973 Christian showed a gross profit of $94,341.48.

The Court makes the following conclusions with respect to each defendant.

1. Rega and Carlton

It is clear that Rega and Carlton were responsible for numerous violations of the anti-fraud and anti-manipulative provisions of the federal securities laws. From the very beginning of this Dennison public offering Rega and Carlton embarked on a course of conduct designed to frustrate the goals of the Dennison offering and to use tradings in the Dennison issues for their own financial gain. The evidence establishes that Carlton through Rega as one of the named underwriters of the issue had

no intention whatsoever to engage in "best efforts" to sell the entire issue. Rega admits that he stopped selling Dennison on May 29, 1972 even though he knew that Carlton was under a responsibility to continue to sell Dennison. This constituted a fraud upon the issuer and the purchasers of the stock in violation of section 17(a) of the Securities Act (15 U.S.C. 77q(a)) and section 10(b) of the Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder. In addition, Carlton was obligated to promptly deposit all the funds that it received from subscribers into the escrow account. (17 C.F.R. 240.15c2-4). The conclusion is inescapable that Rega and Carlton completely disregarded this rule and deposited subscriber funds in a business checking account and commingled these funds with ordinary revenue. Rega and Carlton even failed to comply with basic statutory mandates regulating the distribution of securities. there was testimony at the hearing that a number of subscribers to the Dennison issue did not receive a prospectus. This clearly violated §5(b)(2) of the Securities Act. (15 U.S.C. §77e(b)(2)). A more crucial violation of the securities law occurred in relation to the representation that the offering was being made on an "all or none" basis. Rule 10b-9 of the Commission provides in part:

> "It shall constitute a 'manipulative or deceptive device or contrivance,' . . . to make any representation . . . (1) To the effect that the security is being offered or sold on an "all or none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless (i) all of the securities are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date." (17 CFR 240.10b-9).

The terms of the Dennison offering provided that 3,000,000 shares were being sold on an "all or none" basis. If 3,000,000 shares were not sold within the specified time, then, the funds had to be returned to the subscribers. Thus, it was of the utmost importance that these shares be sold. There was no

convincing evidence that the required number of shares were in fact sold. The escrow account never contained a balance reflecting the sale of 3,000,000 shares. The continuously postponed closing was another indication that something was amiss. Evidence which would have helped persuasively to establish whether 3,000,000 shares were sold would have been the Carlton books and records. However, these books and records were allegedly conveniently destroyed in a "flood."

The Court finds that 3,000,000 shares were not sold and that Rega and Carlton contrived figures calculated to give the appearance that the minimum portion of the issue had been sold. With respect to this, the Court concludes that representing that the offering would be on an "all or none" basis violated Rule 10b-9, as well as §10(b) of the 1934 Act. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1095 (2d Cir. 1972).

The Court also finds that the failure to amend the prospectus to reflect the facts that (1) the issue would not be sold on an "all or none basis;" (2) best efforts would not be made to sell the entire issue; and (3) all monies received from the subscribers would not be deposited in the escrow account at Republic constituted violations of section 5(b)(2) of the Securities Act. (15 U.S.C. 77e(b)(2)). See *Manor, supra,* at 1098-1100.

Rega and Carlton also disregarded the provisions of Rule 10b-6. (17 C.F.R. 10b-6). That rule, in pertinent part, provides that it is a manipulative or deceptive device for "any person who is an underwriter in a particular distribution of securities" or "a broker, dealer, or other person who has agreed to participate or is participating in such distribution," to bid for or purchase such securities until he has completed his participation in the distribution.

A public offering of stock pursuant to a registration statement would clearly constitute a distribution within the meaning of Rule 10b-6. The public offering of the Dennison stock began on April 26, 1972 and continued until July 18, 1972 when the remaining stock was de-registered. Yet during this period—while Carlton was still purportedly acting as Dennison's underwriter—Rega induced M.S. Wien to submit a bid into the pink sheets. This action violated Rule 10b-6. *SEC v. Scott Taylor & Co., Inc.,* 183 F. Supp. 904, 907-08. (S.D.N.Y. 1959). Also during this time Carlton was trading Dennison both with its own customers and with other brokers. This similarly constituted a violation of Rule 10b-6.

Most of the foregoing violations merely set the stage for the manipulative scheme involving the price of Dennison which followed.

Section 9(a)(2) of the Exchange Act (15 U.S.C. §78i(a)(2)) makes it unlawful to use the facility of any national securities exchange "[t]o effect, alone or with one more other person, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others."

It has been held that the practices prohibited by this section with respect to listed securities are also violations of §17(a) of the Securities Act and section 10(b) of the Exchange Act with respect to an over-the-counter security. *SEC v. Resch-Cassin & Co., Inc.,* 362 F. Supp. 964, 975 (S.D.N.Y. 1973). Some of the indicia of price manipulation of an over-the-counter security include price leadership by the manipulator and his dominion and control of the market for the security. *Resch-Cassin, supra,* at 976. The evidence of such a manipulative scheme with respect to Dennison is clear.

As indicated Rega caused M.S. Wien to make a market in Dennison and on June 5, 1972 M.S. Wien appeared in the "pink sheets." On June 15, Carlton began placing quotes in the "pink sheets." From June 15 to 20, Carlton quoted the highest bid-ask prices yet did not purchase a share of stock from another broker. On June 20 Carlton raised its market to .14 bid—.17 ask and maintained that market until the end of October. Again during this period Carlton's purchases from other brokers were insignificant. There is no question that during the period from June to October 1972 Rega and Carlton controlled the market in Dennison. This domination was greatly facilitated by the fact that a substantial percentage of the Dennison issue—allegedly 2,727,000 shares of 3,073,500 shares issued—were in the hands

of Carlton's customers. These customers sold to and purchased Dennison from Carlton at prices set by Rega. Given Carlton's total dominance of the market the scheme worked quite effectively. Carlton initially sold "short" to its customers and purchased the shares again from its customers at lower prices to cove its short position. Also Carlton just cross-traded customers sell and buy orders resulting, of course, in a nice profit for the firm. As a result of all this Carlton was a market unto itself making it appear that in fact there was an independent and free market in Dennison rather than the contrived artificial market which in fact it was.

As we have seen, in the fall of 1972 Rega, now at Christian, prepared to embark on yet another manipulative scheme involving Dennison stock which would prove to be even more profitable. Again—given the complete control of the market—the plan worked quite effectively. In January, February, March, April, and May of 1973 a substantial block of Dennison stock was purchased from Christian-Paine's customers at .12¢ per share. By the end of May, Rega bega to "boost" the price of the stock until by mid-June the stock was being sold at .75¢ per share. During the period of May 25, 1973 to July 5, 1973 hundreds of thousands of shares were cross-traded in Christian at prices arbitrarily set by Rega. During this period the prices charged by Christian for Dennison were far higher than the prices in the "pink sheets" and the prices that other brokers charged Christian for the stock. In short, it is evident that Rega and Carlton beginning in June 1972—and Rega while at Christian-Paine—created an artificial market in Dennison and manipulated the price of the stock within the meaning of §9(a)(2) of the Exchange Act and thus contravened §10b of the Act and Rule 10b5 thereunder and 17(a) of the Securities Act.

During the course of both schemes numerous additional violations of section 17(a) of the Securities Act and §10b of the Exchange Act were committed vis-a-vis the customers. Little need be said about these except to note a few. The artificial prices set and the sales at excessive mark-ups without disclosing the true market price were violations of the securities laws. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943).

Also incomplete confirmations were sent to customers in violation of §15(c) of the Exchange Act and Rule 15c 1-4 thereunder. In contravention of this rule these confirmations (copies of which were received in evidence during the trial) failed to disclose that the firm was acting as principal. (17 C.F.R. 240.15c14). Finally, the "informational" letter prepared by Rega and distributed to the Christian customers clearly violated §17(a) of the Securities Act and §10(b) of the Exchange Act and Rule 10b5 thereunder. For example, this letter encouraging the Christian customers to purchase Dennison did not reveal the firm's retail interest in Dennison nor that Christian would be selling out its large inventory position acquired at prices favorable to it.

2. Coven

Defendant Coven has been charged with having "aided and abetted" the violations by Rega and Carlton.

In *Securities and Exchange Commission v. Spectrum, Ltd.*, 489 F.2d 535, 541 (2d Cir. 1973) the Second Circuit explicitly indicated that in measuring liability as an aider and abettor a negligence standard should be employed. The test, therefore, is whether the "defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity." *SEC v. Management Dynamics, Inc.*, Slip Opinion at 2349, Docket Nos. 74-1680; 74-1686; 74-2148; 74-1842 (2d Cir. March 18, 1975). Knowledge that a violation is being committed and intent to further the illegal act is not required. *SEC v. Spectrum, supra.* It is sufficient if the defendant had reason to know or should have known that an illegal scheme was afoot and that his conduct would contribute to its success. See *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Texas 1971). Under these principles, the Court finds that Coven aided and abetted Rega's and Carlton's violations in several respects.

A crucial element to Rega's scheme was to make it appear that the minimum had in fact been sold. Without this, there could be no closing of the escrow account and the funds had to be returned to the subscribers. If the escrow account had

reflected deposits amounting to at least $300,000, this would have been some evidence that in fact the minimum had been sold. But the escrow account deposits at no time totalled this sum. This should have been some indication that something was amiss. Yet, Coven took the position that it would be enough to close if sufficient funds were available to pay off the issuer. In his view Rega could deposit his checks "net" having deducted his commission and expenses. Coven's understanding attitude and his lack of concern in establishing that the minimum had been sold was very helpful to Rega. However, Coven's assistance did not stop there. In response to the inquiries by Republic, he represented that 3,075,000 shares had been sold. Coven had no basis whatsoever to make this representation and in fact his figures were erroneous at that. The fact that counsel for the issuer was so categorical in his assertion that more than the minimum had been sold went far to persuade the bank that the terms of the escrow agreement had been met. Coven's protestations that his letter was "conditional" on the bank counting the certificates are not persuasive. First, the bank had explicitly requested a written statement from Coven that the minimum had been sold and this is exactly what it received. There is no indication whatsoever on the face of the letter that it was meant to be "conditional." Secondly, if the letter was meant to be "conditional" this would mean that it would be solely the bank's responsibility to determine if the minimum had been sold. In fact, what Coven would be telling the bank is that he thought the minimum had been sold but that he was not sure and that therefore Republic should check to ascertain how many shares had allegedly been sold. Clearly, this is not what the bank had requested.

Subsequently, Coven learned that his statement that 3,075,000 shares had been sold was incorrect in light of the fact that the transfer agent had remitted 3,073,500 shares. Apparently he was informed of this discrepancy by the bank but Coven just concluded that there had been an "erroneous arithmetical computation." He totally failed to make any inquiries to find out *exactly* how many shares had in fact been sold. In sum, Coven's cavalier attitude greatly assisted in furtherance of the scheme.

Following the June 12, 1972 "gathering" at the bank, Coven's negligence became more pronounced. He knew that the underwriters were supposed to use best efforts to sell the remaining shares. Yet, admittedly he made no attempt to inquire from Levin, the attorney for the underwriters, whether Carlton and Stevens-Jackson were continuing to sell the Dennison issue. He assertedly was busy with another matter and therefore could not make the necessary telephone call. Moreover, even though he was in touch with Rega after the June 12 gathering, the Dennison issue never came up since there were more important matters to discuss. It is most difficult to understand why Coven who, according to his testimony, frequently called Levin and the underwriters to learn how the sale of the minimum was progressing suddenly lost interest in the issue and became too busy or concerned with more important matters. Coven's inaction and total disinterest in learning whether the underwriters were attempting to sell the maximum portion of the Dennison issue contributed to the violations by Rega and Carlton with respect to the failure to make "best efforts" to sell the issue.

Coven also aided and abetted Rega and Carlton in violating Rule 10b-6. It appears that Coven had some knowledge beforehand that M.S. Wien was to appear in the "pink shets" making a market in the Dennison stock. Further, this matter was specifically brought to his attention on two different occasions. He did not make the slightest effort to look into the circumstances surrounding M.S. Wien's market. Had he done so presumably he would have been informed that Rega had told M.S. Wien that the Dennison offering had ended and that it was proper to trade the stock. Instead, Coven just assumed that M.S. Wien was trading on a "when issued" basis. Coven's indifferent attitude and his failure to exercise minimum due diligence in this regard facilitated Carlton and Rega's violations of Rule 10b-6.

The Commission has alleged that Coven aided and abetted in other violations such as the purportedly false representation that Stevens-Jackson would act as an underwriter when in fact this firm appeared only as an accommodation to Coven; the commingling of subscriber funds by Carlton and the sale of the stock unaccompanied by a proper prospectus.

With respect to the commingling of funds and the failure to deliver the prospectus, there is little, if any, evidence to connect Coven with these matters. As far as Stevens Jackson appearing as an underwriter as an accommodation to Coven is concerned, the hard fact is that Stevens Jackson did manage to sell 80,000 shares of Dennison. Also a selling group did materialize and did sell some of the shares. These facts belie the charge that Stevens Jackson was only a nominal underwriter and had no intention of making any efforts whatsoever to sell the Dennison issue.

3. Republic

Republic National Bank has been charged with violating the securities laws by disbursing the escrow funds without evidence that the minimum had been sold. The bank was alerted to the fact that something was irregular since the escrow account did not reflect $300,000 evidencing the sale of the minimum. In light of this the bank asked for and received verbal and written assurances that the minimum had been sold. The bank had no reason to suspect that some of these assurances were less than candid. In addition, the bank had been informed that the underwriters were allowed to remit subscribers' funds "net." Finally, the bank undertook to count the certificates being issued before it allowed the escrow funds to be disbursed. While it is true that in retrospect it can be determined that such a count proved nothing since the figures submitted to the transfer agent by Rega were in part contrived, Republic at the time in question had no knowledge or any reason to suspect that such was the case.

The bank has also been charged with aiding and abetting Carlton's commingling of subscriber funds. However, the evidence fails to disclose that the bank knew or had reason to know that such was the case. Therefore the Court finds that Republic neither violated nor aided and abetted any violations of the securities laws.

4. The Salesmen

Levine, Colloff, Corvino and Weinberg have been charged with engaging in a fraudulent sales campaign both during the original offer and the after market.

The evidence establishes that in selling the original issue these four salesmen knowingly made false and misleading statements. They "touted" the stock and used price projections to induce purchases of the stock. Such a practice is fraudulent absent a reasonable basis for the price prediction. *Berko v. SEC,* 316 F.2d 137, 143 (2d Cir. 1963). The salesmen failed to advise the customers of the high risk elements inherent in the investment and did not inform them of the financial condition of the company and its need for working capital. This constituted a failure to state material facts. During the after-market sale the salesmen failed to disclose to their customers that the firm, while making a market in Dennison and acting as principal, was charging them prices much higher than the market price. This constituted a failure to disclose material facts within the meaning of section 17(a) of the Securities Act and section 10(b) of the Exchange Act and rule 10b-5 thereunder. See *Chasins v. Smith, Barney & Co., Inc.,* 438 F.2d 1167 (2d Cir. 1970); *Charles Hughes & Co. v. SEC,* 139 F.2d 434, 437 (2d Cir.), *cert. denied,* 321 U.S. 786 (1943).

In addition, the salesmen all violated their responsibilities to customers by failing to investigate Dennison. A salesman is required to know the security he is recommending. *Hanly v. SEC,* 415 F.2d 589, 597 (2d Cir. 1969). Each of the named defendant salesmen admits he never did fundamental research into Dennison. Nevertheless, from June to September 1972 and May to July 5, 1973 they recommended the stock to their customers. This recommendation without adequate research constituted a violation of the anti-fraud provisions of the acts. *Hanly, supra.*

The evidence also supports the finding that the salesmen aided and abetted the scheme to manipulate the Dennison stock particularly during the May-July 1973 period when the price of the stock zoomed to .75¢ for no apparent valid reason. Given

the rapid price rise, the salesmen should have known that something was amiss. In this respect, the Court notes that Colloff had some concrete basis—other than the price rise—to suspect that trading in Dennison was being manipulated since he was aware of Rega's plan to "boost" the price of the stock.

5. Pascall

Defendant Pascall has been charged with aiding and abetting the fraudulent manipulation. There is no question that Pascall by his order to buy 35,000 shares of Dennison which was filled by M.S. Wien on June 5, 1972 thereby establishing a market on the stock aided and abetted the violation by Rega and Carlton of Rule 10b 6 and the manipulation of the after-market in violation of §10-b of the Exchange Act. Moreover, Pascall, as the resident manager of the West Caldwell branch of Carlton, had direct responsibility for supervising the registered representatives at that branch. To the extent that he neglected his supervisory duties by failing to ensure that the salesmen conducted the sales campaign in a proper fashion he aided and abetted the fraudulent conduct in which such salesmen engaged. See *SEC v. Charles A. Morris & Associates, Inc.*, CCH Fed. Sec. L. Rep. [1972-1973 Transfer Binder] ¶93,756 at 93,307 (W.D. Tenn. 1973).

6. Christian-Paine

The Commission has chosen to file its complaint against Christian-Paine on the theory that Christian was Carlton's "successor." Christian has not been charged with any substantive violations.

Generally the term "successor" applies to corporations wherein one corporation by process of amalgamation, consolidation or legal succession becomes vested in rights and assumes burdens of its predecessor corporation. *Forest Laboratories, Inc. v. Pillsbury Co.*, 452 F.2d 621, 625 (7th Cir. 1971). Moreover, one corporation may be deemed to be the "successor" of another where the circumstances attending the

creation of a new corporation show that it was formed to carry on the business of the old corporation and that, in reality, it is a mere continuation of the old corporation. See *SEC v. Manor Nursing Centers, Inc.*, 340 F. Supp. 913, 920 (S.D.N.Y. 1971), *aff'd*, 458 F.2d 1082, 1094 (2d Cir. 1972). Applying these principles here, and upon the facts set forth hereinabove, the Court finds that Christian was in fact the mere continuation of Carlton and that as such it was Carlton's "successor."

While it is true that the agreement entered into between Carlton and Christian did not on its face provide for a total takeover of all of Carlton's assets and liabilities, subsequent events demonstrate that the parties really intended that Christian would assume Carlton's operations. Thus, by December of 1972 Carlton was for all practical purposes an inactive corporation. The premises it had once occupied were being used by Christian; its former employees now worked for Christian; its customers were switched to Christian and its books and records had been disposed of. It was left with one nominal employee who apparently had no expertise in the trading of stocks and who in fact worked for Christian. In sum, what was once Carlton's business simply became Christian's business. Given all this, the Court finds that Christian was Carlton's "successor."

Injunctive Relief

In deciding whether to issue a permanent injunction in suits of this type the critical area of inquiry is whether "there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972). Moreover, "past illegal conduct is highly suggestive of the likelihood of future violations." *SEC v. Management Dynamics, Inc.*, Slip Op., *supra*, at 2340 (2d Cir. March 18, 1975), and the burden is on the defendants to furnish to the Court some basis for believing that their illegal activities will not be repeated.

With these principles in mind and based on the facts adduced at the trial, the Court finds that there is a reasonable expecta-

tion that the defendants who have been found to have violated the securities laws will continue to engage in similar violations. Christian will also be enjoined since it is really Carlton under another name. Accordingly, in order to protect the investing public, a permanent injunction shall issue enjoining any such future violations with respect to any security.

Submit order on 2 days notice.

Dated: New York, New York
June 30, 1975

s/Lawrence W. Pierce
LAWRENCE W. PIERCE
U.S.D.J.

FOOTNOTES

1. In a somewhat conclusory fashion Republic National Bank has challenged the Court's jurisdiction. The Court finds these arguments without merit.

2. Prior to the trial of this action Levin consented to the entry of a Permanent Injunction by Consent.

3. The original selling period was to be 60 business days commencing on April 26, 1972. This period could have been extended for an additional 30 business days upon the consent of the issuer and the underwriter.

4. Every business day the National Quotation Bureau publishes in its "pink sheets" the wholesale prices on a number of over-the-counter stocks and bonds. These are the prices at which dealers are willing to buy or sell various securities in trades between dealers.

5. One of the members of the Stevens Jackson selling group did not actually stop selling the original issue until on or about June 20 or 21, 1972.

6. Coven did not inform Dennison's president that Carlton had been trading the issue.

7. All the old records were transferred to a basement in Lodi, New Jersey, and subsequently destroyed after they were allegedly damaged in a "flood."

OPINION ON RECONSIDERATION APPLICATION ENTERED AUGUST 19, 1975

UNITED STATES DISTRICT COURT SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-v-

JOSEPH REGA, JR., et al.,

Defendants.

LAWRENCE W. PIERCE, D.J.

MEMORANDUM OPINION

In an Opinion dated June 30, 1975 this Court found that the defendant Bernard J. Coven had aided and abetted the commission of various violations of the securities laws. Coven has moved for reconsideration pursuant to Rule 52(b) of the Fed. R. of Civ. P.

A. Closing in Escrow

Coven contends that, contrary to this Court's findings, the minimum portion of the Dennison issue was in fact sold.[1] In support of this, Coven relies upon evidence that the issuer received from the escrow account $3,814.25 in excess of what it would have been entitled to ($255,000) if only the minimum number of shares (3,000,000) had been sold. It is true that this, considered apart and of itself, would ordinarily tend to show that the minimum was sold. However, this factor should not be

considered in a vacuum and without due regard to all the attendant circumstances surrounding the closing of the minimum. Thus, given the facts that the escrow account never reflected sufficient funds to evidence the sale of the minimum, that the Carlton records which would conclusively establish how many shares of the issue it had sold were mysteriously destroyed, and that the figures submitted by Rega to the transfer agent were contrived, it is difficult to conclude that the minimum was sold.

As another indication that the minimum was sold Coven argues that with the exception of its last check Carlton had deposited gross funds in the escrow account and that the difference between its last check and the gross funds was completely covered by the funds in its account at the Commercial Trust Co. of New Jersey. Apart from the fact that there is no evidence to support the conclusion that all but one of the deposits made by Carlton represented gross funds (see Plaintiff's Exh. 16 & 17) this contention ignores the hard fact that the Commercial Trust Account did not represent solely funds received by Carlton as payment for the Dennison original issue but also included income received by Carlton from other sources. Therefore it is not possible to ascertain which of these monies, if any, reflected funds received for the Dennison issue.

The Court has rested its finding that the minimum was not sold[2] in part on the obvious fact that the escrow account never contained $300,000. With respect to this Coven has again pressed his point that there was no requirement in the Escrow or Underwriting Agreements that the total gross amounts of the proceeds be placed in the escrow account in the event that 3,000,000 shares were sold. In this Court's view this argument is based on a strained reading of these documents. For example, Coven points to section 3.01(b) of the Underwriting Agreement which provided that "*until* said 3,000,000 shares of stock are *sold,* the Underwriters shall deposit all funds received with . . . Republic . . . . " (emphasis his). Apparently in Coven's view this clause supports his contention that the escrow account did not need to reflect funds evidencing the sale of the minimum portion of the issue. How this is so is not made entirely clear. This provision simply states that the underwriters were

under an obligation to deposit *all* the funds received into the escrow account and this obligation would continue until the minimum portion of the offering was sold. Obviously once this event occurred no other funds evidencing sales of the minimum number of shares would be forthcoming.

Coven's argument premised on the Escrow Agreement is of a similar nature and overlooks the fact that section 2(d) of that Agreement clearly envisioned that $300,000 would be deposited in the escrow account. Thus that section read: "In the event that there shall not be $300,000 in the Escrow Account on the Delivery Date, . . . all of the monies in the Escrow Account shall be refunded in full . . . . " The section, therefore, presupposes that the Escrow Account would contain $300,000 once the minimum was sold.

Coven also disputes this Court's finding that he took the position that if the escrow account reflected $255,000 (the monies due to the issuer) then there could be a closing. In his view his opinion was the result of "a studied consideration of all of the relevant documents together with appropriate consultations." (Memorandum at 3). However, as Coven's own testimony demonstrates, this "studied consideration" was highly colored by Coven's preconception that all that was essential was for the escrow account to have sufficient funds to pay the issuer. Thus, he testified as follows:

> Q. How did you determine that with the various commissions and deductions, there was $300,000?
>
> A. I spoke to the underwriters, the escrow account—the company had to get $255,000 to make that issue effective. That is what I kept my eye on. I wanted—I believe that was the amount—$250,000. There was more than $250,000 in that account. That money belonged to my client. That is what the prospectus said, when three million shares were sold, $255,000 belonged to my client and that is what I was there to collect. (Transcript 3640-41).

Further, it appears that this "studied consideration" was premised on the assumption that "more than three million shares had been accounted for." (Transcript 3404). However,

how this "accounting" was reached is not clear since apparently none of the participants of the June 12 "gathering" had any precise idea as to how many shares had been sold. Finally, the Court must note that the atmosphere during this "gathering"—there was testimony that there was bickering, charges and counter charges and even threats of physical force—was hardly conducive to a "studied consideration."

Coven has also challenged the Court's findings with respect to his June 13, 1972 letter to Republic. First, he attempts to explain how he reached the figure of 3,075,000 shares sold and again denies that the check deposited by Stevens on June 12, 1972 for $7,506.25 had any connection with his representation of the number of shares sold. In this respect he argues that there were no original issue shares sold past May 30, 1972 and, therefore, the Stevens check represented shares included in the amount given to Coven as the number of shares sold by Stevens.

Coven's current explanation as to how he reached the 3,075,000 figure differs markedly from his testimony at trial. Now he states that he arrived at this figure by simply adding the number of shares which Stevens represented in its June 13, 1972 letter to Republic as having been sold (351,000 shares) to the number of shares Carlton had represented that it had sold. (2,724,000 shares).[3] While it is true that at trial Coven testified that he had been told that Stevens had sold 351,000 shares (Transcript 3393) the record does not reflect that he was told by anyone prior to June 13, 1972 the exact number of shares that Carlton had sold. Indeed, his testimony in this regard is quite imprecise. He testified that he was informed by Levine that Carlton "had done more than the minimum" but did not ask how much more than the minimum. (Transcript 3500). Later, he again testified in the same vein. (Transcript 3578-80). At another point he stated that his figure was based on information received from Stevens and Carlton. (Transcript 3415-16).

Coven's argument that the $7,506.25 check had to represent shares sold on or before May 30, 1972 is also contradicted by his testimony. He testified that Stevens was selling the original issue during June. (Transcript 3518-19). Moreover, it would appear that at the time of the June 12 "gathering" it was

thought that the closing scheduled was for exactly the minimum. The president of the issuer was under that impression (Transcript 81) and so was Stevens' representative. (Transcript 3163). Also this would explain Coven's own concern that the escrow account reflect at least $255,000—the amount due to the issuer if the 3,000,000 shares had been sold. Thus the appearance of an additional 75,000 shares in Coven's June 13, 1972 letter to the bank could be accounted for by inferring that Coven took the $7,506.25 check to represent the sale of an additional 75,000 shares. The Court concludes that while Coven may have had *some* limited grounds for asserting that 3,000,000 shares had been sold he had no basis whatsoever for making the categorical representation that exactly 3,075,000 shares had been sold.

With respect to the June 13, 1972 letter Coven again argues that it was "conditional." The Court has rejected this contention and no additional factors have been presented which would justify changing that finding. Coven also attacks this Court's finding that Republic explicitly requested a statement from Coven that the minimum was sold. In his view the bank just wanted to determine the amount of monies due to the issuer and the underwriters. While it is true that the bank wanted to confirm what funds it was supposed to disburse, it also wanted some assurances that the minimum had been sold. This Court's finding in this respect was in part grounded on Coven's own testimony. Thus, he testified as follows:

> Q. Sir, prior to adjourning at the bank, the Republic National Bank, did Republic request any letter to be sent to them by either yourself or Mr. Ziffer?
>
> A. Not by Ziffer. They requested a letter from me.
>
> Q. What was the purpose of the letter that they requested from you, if you recall?
>
> A. They wanted to confirm, basically, for their records in some official way the number of shares sold and the shares issued fully paid and as to how the funds were to be distributed. (Transcript 3411).

Having testified in that fashion Coven now argues that the "record is absent of any proof as to what if *any* extent the Bank relied on [his] letter . . . . " (Reply Memo at 5, emphasis his). As Coven would have it, the bank did not rely on the letter (which as Coven himself testified it had specifically requested "to confirm . . . in some official way the number of shares sold") simply because it took the added precaution of counting the number of shares. Not only does this argument run contrary to a realistic interpretation of the sequence of events at the June 12 "gathering" but again the record shows that there is no basis for such sweeping statements. Thus a bank official testified as follows:

> Q. Mr. Dallal, did Republic National Bank to your knowledge other than the counting of the certificates actually issued, take any steps to ascertain if the certificates were, in fact, sold?
>
> * * * * *
>
> A. After discussion with our house counsel we deemed it satisfactory that the letter from the issuer's counsel plus the two statements of accounting from the underwriters plus the counting of the certificates was adequate. (Transcript 948-49).

Coven also questions this Court's statement that in arriving at his figures "Rega posited as a predicate that 3,075,000 shares were in fact sold as represented by Coven." In Coven's view this is pure conjecture. As the Court made clear in its Opinion it based its statement on the figures submitted by Rega to the transfer agent. It cannot be contradicted that these figures when added to the number of shares Stevens claimed to have sold totalled 3,075,000 shares—exactly the number of shares Coven had stated had been sold in his June 13, 1972 letter. Given these figures the inference is inescapable that Rega was aware of Coven's representation. Otherwise, it is difficult to explain how Rega's odd number of certificates to be issued in "street name," 1,000,145 shares, coincidentally matched the exact figure needed to total Coven's estimate of 3,075,000 shares.

B. Best Efforts Portion

Coven has argued that since Carlton had begun trading the Dennison issue on June 2, 1972 this effectively terminated the issue and Coven could do nothing to alter this situation since the failure to use "best efforts" had already occurred. Since he had no knowledge of Carlton's trading, the argument continues, Coven could not have aided and abetted Carlton's failure to use its "best efforts."

In this Court's judgment this argument misses the point. There is no question that Carlton was under an obligation to use its "best efforts" to sell the remaining portion of the Dennison issue. Coven as the drafter of the Underwriting Agreement and the attorney for the issuer must have been aware of this obligation. Yet despite this Coven admittedly made no efforts whatsoever to ascertain whether Carlton was complying with the terms of the Underwriting Agreement. Although he was in contact with Rega during this period he failed to inquire as to the progress of the Dennison issue. His explanation that "[t]here were other problems that came up" (Transcript 3464) and that there was "something more serious" (Transcript 3504) to discuss is inadequate. Coven's lack of diligence permitted Carlton to evade its responsibility of engaging in "best efforts." His indifferent attitude and disinterest was of assistance to Carlton's violation of its continuing duty. Coven's suggestion that in order to have aided and abetted in this violation he must have had some knowledge that Carlton was trading the issue is not persuasive. The Court's finding that Coven aided and abetted this violation is keyed to Coven's total failure to make any inquiries with respect to the "maxi" portion of the offering. Had Coven made an attempt to investigate and been misled by Rega or someone else's representations this would have presented a somewhat different situation.

C. M. S. Wien and the "Distribution"

Coven has alleged that contrary to the Court's finding the "distribution" of the Dennison issue terminated on May 30, 1972 and in any event no later than June 2, 1972. The argument

appears to be that since Carlton had ended its participation in the "distribution" by either of these dates neither it nor Rega could have violated Rule 10b-6 by inducing M.S. Wien to submit a bid into the pink sheets on June 2, 1972. *A fortiori* Coven could not have aided and abetted any such violation.

Whether Carlton was participating in the "distribution" of the Dennison issue at the time M. S. Wien was persuaded to appear in the pink sheets is a question which is bottomed on essentially factual considerations. It would appear, therefore, that the Court may have set a somewhat restrictive demarcation point for the termination of the "distribution" when it intimated that the "distribution" of the Dennison issue ended on July 18, 1972 simply and solely because it was then that the stock was deregistered. The term "distribution" as used in Rule 10b-6 has been said to have a broad meaning. It has been defined as "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *R. A. Holman & Co. v. Sec.*, 366 F.2d 446, 449 (2d Cir. 1966) (citation omitted). It may also refer to an "intensive campaign" in the sale of a security, *Lawrence Rappe & Co.*, 40 S.E.C. 607 (1961), or to a "major selling effort" of a security. *Gob Shops of America, Inc.*, 39 S.E.C. 92, 103 n. 25 (1959). In short, "distribution" may include "any selling activity, based upon either the magnitude of the offering or the selling efforts and selling methods utilized which constitutes a departure from casual trading." E. Weiss, *Registration & Regulation of Brokers & Dealers* 113 (1965). Gauged by these definitions there is no question that at the time it induced M. S. Wien to submit its bid Carlton was engaged in an "intensive campaign" and "major selling effort" in connection with the Dennison issue and hence was participating in a "distribution" within the meaning of Rule 10b-6. Thus, between June 2, and June 20, 1972 Carlton sold approximately 380,000 shares of Dennison to its customers and in most instances these were solicited transactions. The sale of such a large block of shares may be said to constitute a "distribution." *Bruns, Mordeman & Co.*, 40 S.E.C. 660 (1961). It is clear, therefore, that Carlton through Rega when persuading M. S. Wien to trade the Dennison issue violated Rule 10b-6.

The Court found that Coven aided and abetted this violation. As the Court has indicated there was credible testimony that Coven knew beforehand that M. S. Wien was going to appear in the pink sheets. Lian, a trader at Stevens, testified that he was told by Coven that "the brokerage firm of M. S. Wien & Company would be making a market in the [Dennison] stock." (Transcript 1031). While Lian conceded that it was "possible" that this information may have come from someone else, namely Ziffer, he maintained that Ziffer himself could only have obtained this information from Coven. Moreover, the general thrust of his testimony was that the source of his knowledge that M. S. Wien would appear in the pink sheets was Coven. Coven's suggestion that Ziffer may have obtained this information from Rega and in turn passed it on to Lian has no support in the record. In fact, Ziffer himself testified that he had no knowledge beforehand that M. S. Wien would be trading the issue. Rega, of course, denied, having conversations with the trader at M. S. Wien during which he told him that the Dennison issue could be traded. Therefore, Coven's supposition to explain Lian's testimony is pure conjecture.

Coven has also argued that since at the time M. S. Wien appeared in the pink sheets a minimum closing had not yet taken place M. S. Wien could only have been trading on a "when issued" basis since no other legal alternative was possible. Coven cites no authority for this proposition and upon consideration this Court has determined that under the circumstances of this case his argument is not persuasive.

The trader at M. S. Wien testified that he was not making a "when issued" market but rather a regular market (Transcript 1540, 1541) and that he hoped to get the stock in the open market (Transcript 1543) which in fact he did by purchasing most of the shares he was "short" from Carlton. (Transcript 1533). Despite this Coven asserts that the M. S. Wien trade could only legally be on a "when issued" basis. But the Court fails to see how this must be necessarily so simply because the issue had not yet closed. Assuming that M. S. Wien knowing the

underlying circumstances had sold the stock to an innocent purchaser, Coven's position would mean that M. S. Wien would have a total defense to its contractual obligation to deliver the stock since it was legally impossible for it to make a regular market. However, on closer examination, it would appear that M. S. Wien could propose to make a regular market although the minimum had not closed. There is no inherent legal impossibility in committing oneself to such an obligation. The fact that the issue had not closed and, therefore, no stock was yet available would create certain risks in the transaction but this goes to the question o the advisability of the contract and not to its legality.

Also the Court notes that judging from the testimony at trial Coven was not as categorical in his assertion that M. S. Wien could *only* be trading on a "when issued" basis at the time this matter was specifically brought to his attention. There was testimony from two different witnesses that he had then said that M. S. Wien was "probably" trading on a "when issued" basis and that this could be done. (Transcript 1394, 3153, 3155). Coven's present position is, therefore, somewhat at odds with his prior opinion.

In light of what has been said the Court adheres to its finding that Coven aided and abetted the Rule 10b-6 violation.

D. Appropriateness of Injuctive Relief

In deciding to grant injuctive relief against Coven the Court was not unmindful of the possible adverse impact this may have on his professional career. See Mathews, *Liabilities of Lawyers under the Federal Securities Laws,* 30 The Business Lawyer 105 (1975). Nevertheless, while this is certainly an important factor to be weighed, it should be emphasized that the "public interest, when in conflict with private interest, is paramount." *SEC v. Culpepper,* 270 F.2d 241, 250 (2d Cir. 1960).

The testimony at trial in this case revealed that Coven was not just a minor actor in the events surrounding the distribution of the Dennison issue who was misled by other wrongdoers. Rather he provided the impetus for the launching of the issue.

He drafted the pertinent documents as counsel for the issuer and sought out the underwriters and the escrow agent. It was to him that the issuer and at least one of the underwriters (Stevens) consistently turned for information respecting the Dennison distribution. In this respect it is noteworthy and significant that although another attorney was supposedly acting as counsel for Stevens when problems arose or questions concerning Dennison had to be answered Stevens looked to Coven for guidance. Further, it was in part to Coven that the bank turned for some assurance that the minimum had been sold. In short, Coven played a key role in the Dennison distribution.

Yet despite this Coven displayed very little if any sensitivity to his responsibilities. He was oblivious to the number of red flags along the way indicating that something was amiss with the Dennison issue. The fact that the escrow account did not have the correct amount of funds, that M. S. Wien was trading the stock and to use Coven's own words possibly "pirating" the issue, that he had no precise idea as to the number of shares sold, that his estimate had proven to be erroneous—all this and more was ignored by Coven. Even when admittedly Coven became aware of Rega's misdeeds, his actions reflected little dismay at what had transpired. Though he professed to be "angry" at Rega, shortly thereafter he embarked on a new issue again with Carlton as the underwriter. Also the Court notes that though Republic National Bank claimed not to have authorized the use of its name as escrow agent following the Dennison closing, the bank was listed as an escrow agent for a distribution in which Coven was counsel for the issuer.

In fairness the Court should note that Coven has indicated—without conceding any wrongdoing on his part—that subsequent to the Dennison issue he has been very strict in the procedures employed when involved in a distribution of the Dennison type. However, such an avowal that the practices complained of have ceased is insufficient to defeat an application for injunctive relief.

Having assessed the facts elicited at trial and having weighed all the proper considerations the Court adheres to its determination to issue a permanent injunction against Coven.

The motion to reconsider is denied.
SO ORDERED.

Dated: New York, New York
August 18, 1975

s/L. W. Pierce
Lawrence W. Pierce
U.S.D.J.

FOOTNOTES

1. Indeed, Coven goes so far as to claim that the SEC "throughout the trial of [the] action never seriously proposed that at least 3,000,00 shares had not been sold." (Reply Memorandum at 10). Little need be said about this except to note that it is at variance with and completely ignores the Commission's position as expressed in its pretrial and post-trial submissions.

2. Coven asserts that the Court has adopted an "incongruous position" in finding that, though the minimum was not sold, the underwriter had to exercise "best efforts" to sell the remaining portion of the issue. This argument is not well taken. At the point of the closing there was an obligation to return the funds to the subscribers if it was found that the minimum had not been sold. However, Rega made it appear that the minimum had in fact been sold. Having made such a misrepresentation, the Court sees nothing "incongruous" in requiring that the underwriter fulfill its obligation under the Underwriter Agreement, as represented to the public in the prospectus, and engage in "best efforts" to sell the remaining shares. Otherwise an underwriter would unilaterally divest itself of the obligation to engage in "best efforts" which arises when it represents that a minimum portion of an issue has been sold simply because a Court later finds that representation to have been false.

3. Coven has gone into a somewhat lengthy explanation in an effort to show that contrary to the Court's finding the shares issued to Carlton were exactly the number it requested. Aside from the fact that the direct bearing of this point on the Court's findings with respect to Coven is not made clear, the Court notes that in the course of the explanation two arithmetical errors were made in order to arrive at the desired result. It should be remembered that Carlton claimed to have

sold 2,724,000 shares. Yet the delivery bill (Plaintiff's Exh. 22) indicated that it had received a total of 2,727,000 shares. Despite this Coven claims that the delivery bill was incorrect (as shown by the supporting schedules) and should have instead reflected 2,547,700 shares. Coven therefore concludes that there was a shortage of 177,300 shares. But assuming that Coven's assumptions are correct and that the delivery bill should have been for 2,547,700 shares then there was a shortage of 176,300 shares (2,724,000 minus 2,547,700) and not as Coven claims 177,300 shares. Coven then attempts to account for his supposed shortage of 177,300 shares by subtracting from the number of shares indicated in the listing annexed to the delivery bill to Stevens (261,300 shares) 84,000 shares. This computation would, of course, result in the desired figure of 177,300. Finally, Coven asserts that if the figure of 177,300 (which he has erroneously arrived at in the first place) is added to the number of shares in the listing annexed to Carlton's delivery bill (2,547,700 shares) the result is that Carlton received 2,724,000 shares—the exact number of shares ordered by Carlton. But as a matter of simple arithmetical computation Coven's conclusion is erroneous since 2,547,700 shares plus 177,300 shares equals 2,725,000 shares not 2,724,000 shares as Coven represents. In short, Coven's exercise demonstrates nothing but that as the Court found the number of shares issued to Carlton did not coincide with the number it had ordered.

APPENDIX "D"
STATUTES AND RULES INVOLVED

RULE 10-b-9 UNDER THE SECURITIES EXCHANGE ACT OF 1934, 17 CFR 240.10b-9.

§240.10b-9: Prohibited representations in connection with certain offerings.

(a) It shall constitute a "manipulative or deception device or contrivance," as used in section 10(b) of the Act, for any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation:

(1) To the effect that the security is being offered or sold on an "all-or-none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless (i) all of the securities being offered are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date; or

(2) To the effect that the security is being offered or sold on any other basis whereby all or part of the consideration paid for any such security will be refounded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering or distribution being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless (1) a specified number of units of the security are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date.

(b) This rule shall not apply to any offer or sale of securities as to which the seller has a firm commitment from underwriters or others (subject only to customary conditions precedent, including "market outs") for the purchase of all the securities being offered.

15 U.S.C. 77q(a), SECURITIES ACT OF 1933 §17(a)

Sec. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. §78j(b), SECURITIES EXCHANGE ACT OF 1934 §10b

Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

No. 78-956

In the Supreme Court of the United States

OCTOBER TERM, 1978

BERNARD JAY COVEN, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 4a-26a) is reported at 581 F.2d 1020. The initial opinion of the district court (Pet. App. 29a-56a) is reported at [1975-1976] CCH Fed. Sec. L. Rep. ¶ 95,222. The opinion of the district court on motion for reconsideration (Pet. App. 57a-69a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on June 2, 1978. A petition for rehearing was denied on August 7, 1978 (Pet. App. 27a-28a). On October 24, 1978, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including December 4, 1978. On November 27, 1978, Mr. Justice Marshall further extended the time for filing to and including December 15, 1978, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether reckless conduct that aids and abets violations of Section 17(a) of the Securities Act of 1933 is a sufficient basis for liability in an injunctive proceeding brought by the Securities and Exchange Commission.

2. Whether the court of appeals properly affirmed the district court's injunction against petitioner on a ground other than that relied on by the district court.

STATEMENT

In July 1973 the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against 11 defendants, alleging violations of registration, anti-fraud and anti-manipulation provisions of the federal securities laws [1] in connection with the public

[1] Sections 5(b) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77e(b) and 77q(a); Sections 10(b) and 15(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and 78*o*(c)(2), and Rules 10b-5, 10b-6, 10b-9, and 15c2-4 promulgated thereunder, 17 C.F.R. 240.10b-5, 240.10b-6, 240.10b-9, and 240.15c2-4.

offering and trading of common stock of Dennison Personnel, Inc. ("Dennison") (J.A. 12a-18a).[2] Petitioner, an attorney specializing in securities law, was in charge of the public offering, and the complaint alleged that he aided and abetted most of the violations of the other defendants (*ibid.*).

The district court found that numerous violations of the securities laws had been committed by the defendant underwriter, its president, and various salesmen (Pet. App. 44a-49a, 53a-55a). It also found that petitioner had aided and abetted three of the violations (Pet. App. 49a-52a).

The first violation that the district court found that petitioner aided and abetted arose from the closing of the 3,000,000 share "all or none" portion of the Dennison stock offering.[3] The district court concluded that this closing violated Section 10(b) of the Securities

[2] "J.A." refers to the Joint Appendix filed in the court of appeals.

[3] The Dennison registration statement filed with the Commission provided for the offer of 6,000,000 shares of stock. The first 3,000,000 shares were to be sold under an "all or none" formula. As described in an exhibit to the registration statement drafted by petitioner, the underwriter was required to rescind all subscriptions and repay the purchase price to investors if it was unable to sell 3,000,000 shares within a stipulated period. To implement this "all or none" formula, funds received from investors were to be held in escrow and could not be disbursed until the minimum number of shares had been sold. This escrow arrangement was described in the prospectus disseminated to public investors (Pet. App. 7a).

Exchange Act of 1934 as implemented by Rule 10b-9 (Pet. App. 45a-46a) because the underwriter disbursed the proceeds of the offering to the issuer without selling the minimum number of shares specified in the registration statement (Pet. App. 49a). Petitioner aided and abetted the violation by advising the issuer that the closing could take place (*id.* at 50a-51a) and by representing unconditionally in an opinion letter to the escrow agent that 3,075,000 Dennison shares had been sold. Petitioner "had no basis whatsoever to make this representation" and "totally failed to make any inquiries" to find out how many shares had in fact been sold (*ibid.*).[4]

The district court also found that the underwriter had violated Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act as implemented by Rule 10b-5, by failing to use its "best efforts" to sell the entire Dennison issue, contrary to representations in the registration statement (Pet. App. 33a-34a, 44a-45a). The district court held that petitioner aided and abetted that violation by failing to make inquiry of the underwriter's counsel regarding the underwriter's sales efforts and by his "total disinterest in learning whether the underwriters were attempting to sell the maximum portion of the Dennison issue" (Pet. App. 51a).

Finally, the district court found that petitioner's "failure to exercise minimum due diligence" aided

[4] The escrow agent had requested a letter from petitioner assuring it that the requisite number of Dennison shares had been sold before releasing investor funds from the escrow account (Pet. App. 36a).

and abetted manipulative trading by the underwriter and another brokerage firm that bid for and purchased Dennison stock during the distribution period, in violation of Section 10(b) and Rule 10b-6 (Pet. App. 51a).

In view of the serious nature of the securities law violations that it found, and the expectation that the defendants were likely to engage in similar future violations (Pet. App. 55a-56a), the district court enjoined the underwriter, its president and petitioner from violating anti-fraud and anti-manipulation provisions of the securities laws, including Section 17(a) of the Securities Act of 1933 (J.A. 43a-51a).

The court of appeals reversed the district court's finding that petitioner had aided and abetted the second and third violations (Pet. App. 26a). But it affirmed the finding that petitioner had aided and abetted the first violation when he caused the release of the proceeds contrary to the escrow agreement and contrary to the representations contained in the Dennison registration statement and prospectus (Pet. App. 22a-23a). The court concluded that this release of funds "plainly 'operated as a fraud' upon the public" (Pet. App. 21a), and that petitioner's false statement in his letter to the escrow agent that 3,075,000 shares had been sold was made in "reckless disregard" of its truth or falsity (Pet. App. 23a).[5] Under these circumstances, the court concluded, petitioner could be enjoined as an aider and abettor of a violation of

[5] In finding petitioner to be an aider and abettor, the court pointed out that he could anticipate that his letter was "likely to be used in furtherance of illegal activities" (Pet. App. 23a).

Section 17(a) of the Securities Act of 1933 (Pet. App. 21a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Review by this Court is not warranted.

1. Petitioner argues (Pet. 3) that he was held liable for "simple negligence" and that a conflict exists among the circuits regarding the standard of culpability in actions under Section 17(a) of the Securities Act of 1933. Contrary to petitioner's assertion, however, the court of appeals did not find that petitioner was merely negligent; the court held that his conduct was "reckless" (Pet. App. 23a). Accordingly, this case does not present the question whether "simple negligence" would be sufficient to sustain the injunction granted here.[6]

In any event, even if petitioner's conduct had been found to be only negligent, the decision below would

[6] In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), which held that *scienter* must be proved in a private damages action under Section 10(b) of the Securities Exchange Act, this Court left open the question "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." Courts of appeals subsequent to *Hochfelder* have sustained findings of liability under Section 10(b) based on recklessness. See *Nelson* v. *Serwold*, 576 F.2d 1332, 1337-1338 (9th Cir. 1978); *Rolf* v. *Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 46 (2d Cir. 1978), cert. denied, No. 78-560 (Dec. 14, 1978); *Wright* v. *Heizer Corp.*, 560 F.2d 236, 251 (7th Cir. 1977); *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir. 1977). See also *Coleco Industries, Inc.* v. *Berman*, 567 F.2d 569, 574 (3d Cir. 1977).

not conflict with the holding of any other circuit. Each court of appeals that has addressed the question has determined that, in statutory proceedings for injunctive relief brought by the Commission under Section 17(a), the Commission is not required to prove *scienter*, and that negligent wrongdoing may serve as the basis for an injunction prohibiting future violations of Section 17(a). See *SEC* v. *American Realty Trust*, 587 F.2d 1001, 1005-1007 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 541 (1st Cir. 1976); *SEC* v. *Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970); *SEC* v. *Van Horn*, 371 F.2d 181, 186 (7th Cir. 1966). Petitioner has not cited any court of appeals decision that holds that *scienter* is required in an injunctive proceeding brought by the Commission under Section 17(a).[7]

Nor does this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), require the Commission to prove *scienter* in injunctive proceedings under Section 17(a).[8] As the court of appeals rea-

[7] Petitioner's reliance on *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977), is unwarranted. Although the court in *Sanders* stated (*id.* at 796) that an action under Section 17(a) could not be based on negligent wrongdoing, the court was considering a private damages action. One of the primary considerations in *Sanders* was that judicial creation of a damages remedy for negligence would disrupt the carefully drawn limitations that Congress prescribed in the express private remedy provisions of the Act. *Id.* at 795-796. That concern is not applicable here, because the present action is a government enforcement proceeding.

[8] *Hochfelder* left open the question whether *scienter* is necessary in an injunctive proceeding brought by the Commission under Section 10(b). 425 U.S. at 194 n.12.

soned (Pet. App. 14a-20a), *Hochfelder* depended on the language and legislative history of Section 10(b). That statute prohibits "any manipulative or deceptive device or contrivance" in contravention of Commission rules in language which this Court in *Hochfelder* viewed as connoting intentional wrongdoing. Section 17(a), by contrast, prohibits the making of "untrue" statements, the "omission to state a material fact," and engaging in a course that "*operates or would operate* as a fraud or deceit" (emphasis added).[9] These provisions of Section 17(a) cast a broader net than does Section 10(b), and they therefore do not require proof of intentional misconduct.

Moreover, despite petitioner's assertion (Pet. 10), this case does not raise the question whether *scienter* is required to sustain an injunction under Rule 10b-9. The court of appeals held only that petitioner violated Section 17(a) of the Securities Act of 1933 (Pet. App. 6a, 21a). It did not consider the question whether petitioner's misconduct also violated Rule 10b-9. In any event, petitioner cites no decision, and we are aware of none, that supports his contention that *scienter* must be proven in an injunctive proceeding under Rule 10b-9.

2. Petitioner further argues that the court of appeals deprived him of due process of law by holding

[9] The court of appeals here stated that "the clear import of the critical phrase * * * 'operates as a fraud,' is to focus attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible" (Pet. App. 17a; emphasis in original). See also *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 212.

that he violated Section 17(a) when the district court's opinion did not rely on that provision (Pet. 16-17).

But the first cause of action in the Commission's complaint expressly charged that petitioner violated, *inter alia,* Section 17(a) as a result of his involvement in the closing of the "all or none" portion of the offering (J.A. 12a-16a).[10] The district court found that petitioner, by participating in the closing, had violated the securities laws. Although the court's opinion discussed only Rule 10b-9 in that connection, the misconduct was also clearly encompassed by Section 17(a). See, *e.g., A. J. White & Co.* v. *SEC,* 556 F.2d 619, 622 (1st Cir.), cert. denied, 434 U.S. 969 (1977); *SEC* v. *Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1094-1095 (2d Cir. 1972).[11]

Under these circumstances, the court of appeals did not deny petitioner due process of law by holding that he had aided and abetted a violation of Section 17(a), even though the opinion of the district court referred only to Rule 10b-9. Even if the district court had overlooked Section 17(a) in this respect, it is well settled that an appellate court may affirm a judgment on any ground that the law and record permit, including a ground not considered by the lower court. See

[10] The fourth cause of action charged petitioner with violating Section 10(b) and Rule 10b-9 based on his involvement in the closing (J.A. 18a).

[11] The district court's injunction incorporated the prohibitory language of Section 17(a). See J.A. 44a-45a.

Massachusetts Mutual Life Insurance Co. v. *Ludwig*, 426 U.S. 479 (1976).

3. Finally, petitioner argues that the court of appeals erred in failing to remand the case to the district court for reconsideration of the appropriateness of injunctive relief after it affirmed only one of the district court's findings of liability.

But petitioner has made no showing that the court of appeals abused its discretion in denying his request for remand. The court specifically set aside the lower court's injunction to the extent that it was based on findings of liability that were vacated (Pet. App. 26a). There was thus no need for a remand and the expenditure of additional resources. Appellate courts are capable of determining the necessity for injunctive relief.[12] Because petitioner played a key role in the Dennison distribution and recklessly caused the release of investor funds contrary to the terms of the escrow agreement, registration statement and prospectus, injunctive relief was appropriate here.[13]

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[12] See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 197, 201 (1963); *SEC* v. *American Realty Trust*, 587 F.2d 1001, 1007 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 543 (1st Cir. 1976).

[13] An injunction is properly based on a single serious violation of the securities laws. See *SEC* v. *Blatt*, 583 F.2d 1325, 1334-1335 (5th Cir. 1978); *SEC* v. *Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 90 (S.D.N.Y. 1970), modified, 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 1979

☆ U. S. GOVERNMENT PRINTING OFFICE: 1979 286353 309

No. 78-956

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Supreme Court of the United States
October Term, 1978

BERNARD JAY COVEN,
Petitioner,

-against-

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Petitioner's Supplemental And Reply Brief

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BERNARD JAY COVEN,
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-against-

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITIONER'S SUPPLEMENTAL AND REPLY BRIEF

STATEMENT

The Respondent's "Statement" is misleading in several instances. The portion of the injunction before this Court on this petition solely relates to Rule 10b-9 which portion was affirmed by the Court of Appeals (P. App. 1a-3a).[1] The language employed to enjoin petitioner is, in haec verba, that of Rule 10b-9. The statement found in Note 11 of Respondent's Brief (P. 9) to the effect that the injunction remaining after the decision of the Court of Appeals incorporated the prohibitory language of §17(a), is in error. Another misleading reference appears in the first full paragraph of page 9 of Respondent's Brief, stating that the first cause of action of the Commission's complaint expressly charged that petitioner violated §17(a). The first cause of action was not sustained as against the petitioner. The District Court found that the underwriter, in improperly

[1]P. App. refers to Petitioner's Appendix.

representing "that the offering would be an "all or none" basis, violated Rule 10b-9 as well as 10b of the 1934 Act" (P. App. 46a) and held the petitioner as an aider and abetter of such violation. The District Court submised that the underwriter had "contrived figures calculated to give the appearance that the minimum portion of the issue had been sold" (P. App. 46a). The District Court did not find that the petitioner knew or had the ability to determine that the underwriter's figures were "contrived." Indeed, the figures if "contrived" did not invite inquiry as the issuer, petitioner's client, received the proceeds of the sale of 73,500 shares *in excess* of the minimum for which the issue was paid in full. (P. App. 57a). The statement, contained on page 5 of the Respondent's Brief (first full paragraph), that petitioner had been enjoined by the District Court from violating various provisions of the Securities Laws "including Section 17(a) of the Securities Act" is, again, in error. The petitioner was, prior to reversal by the Court of Appeals, enjoined from further violations of Rules 10b-5, 10b-6 and 10b-9. Those violations and related portions of the injunction with respect to 10b-5 and 10b-6 were reversed by the Court of Appeals. It is the application of the law to §10b, as implemented by Rule 10b-9 that is before this Court.

ARGUMENT

1. There is no dispute that the District Court held the petitioner to be an aider and abettor of a violation of §10b "as implemented by Rule 10b-9" (R. Br. pp. 3-4).[2] The Respondent argues that while petitioner was not found by the District Court to have aided and abetted a violation of §17(a) nonetheless, petitioner violated §17(a). Respondent argues that this is so because §17(a) is broader in scope than §10(b) (R. Br. p. 8). This conclusion is both unsound and lacking in logic. For one, petitioner can hardly be held to have aided and abetted a violation

[2]R. Br. refers to Respondent's Brief.

which had not been found to have been committed by the person said to have been aided and abetted. The respondent avoids the difficulty of legal argument by simply stating, *ipse dixit,* that "[P]etitioner violated Section 17(a) of the Securities Act of 1933" (R. Br. p. 8). The respondent does not descend from the general to the particular. Nowhere in the brief of respondent is there any reference to any particular subsection of §17(a), ignoring the various treatment of each of these subsections by the Courts as indicated in petitioner's Main Brief at pp. 10-16 and supplemented herein. In arguing that the "provisions of Section 17(a) cast a broader net than does Section 10(b)" (R. Br. p. 8) respondent concludes "that they therefore do not require proof of intentional misconduct." Both the premises and conclusion are in error. Section 10b and Rule 10b-9, which implements it, are broader in scope than §17(a). Section 10b employs the phrase "*in connection* with the purchase or sale" and 10b-9 employs the phrase "*in connection* with the offer or sale." §17(a) restrictively refers to "*in* the offer or sale." See, *Financial Programs, Inc. v. Falcon Financial Services, Inc.*, 371 F. Supp. 770 (D. Oregon 1974). In *SEC v. Penn Central,* CCH Sec. L. Rep. ¶96,461, page 93,640 (E.D. Pa. 1978) Chief Judge Lord opining on the distinction stated:

> Section 17(a) of the Securities Act of 1933, by contrast, reaches only fraud "in the offer or sale" of securities. Quite clearly, the omission of the words "in connection with" makes the scope of §17(a) narrower than that of §10b in that the former requires a closer relationship between the fraud and the securities transaction.

In similar view, the Court in *Resource Investors Group v. Natural Resource Investment Corp.*, CCH Sec. L. Rep. ¶96,752, p. 94,944 (E.D. Mich. 1978), said:

> Several recent cases have held that conduct occurring after a sale cannot be the basis of liability under section 10(b) or Rule 10b-5. Onashi v. Verit Industries, 536 F.2d 849 (9th Cir. 1976); Wolford v. Equity Resources Corp., 424 F. Supp. 670 (S.D. Ohio 1976); Kogan v. National Bank of North America, 402 F.Supp. 359 (E.D.N.Y. 1975). * * *

Section 17(a) of the Securities Act of 1933 is even narrower than Rule 10b-5 in that the fraud must actually be in the offer or sale itself, rather than in connection thereto.

It also may be noted that Rule 10b-9 contains the words "offer or sale" as does §17(a). It would thus appear that §10b as implemented by Rule 10b-9 is, thus *a fortiori,* broader in scope than §17(a).

There is a further question left unresolved by respondent, the application of §17(a) "offer or sale" to the facts of this case. The disputed closing did not involve an "offer or sale" within the meaning of §17(a). See, *SEC v. Savoy Industries, Inc., et al,* CCH Sec. L. Rep. ¶96,497, p. 93,876 (D.C. Cir. 1978); *Resource Investors Group v. Natural Resource Investment Corp.,* cited supra.

2. Conflicts continue in the various circuits with respect to whether scienter must be alleged and proved against one charged as an aider and abettor both under §10b and §17(a). In *SEC v. Blatt, et al,* 583 F.2d 1325 (5th Cir. 1978), the Court held that scienter is required to be alleged and proved in 10b-5 SEC enforcement actions, citing this Court's opinion in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). The opinion noted that since Congress did not contemplate private actions under this section, it follows logically that the scienter requirement implicit in the statute must have been intended for SEC enforcement actions (Note 21). In *SEC v. Willis,* CCH Sec. L. Rep. ¶96,712 (D.C. 1978) the Court held that *Hochfelder* required proof of scienter in §10b SEC enforcement actions. The Court held that with respect to §17(a)(3) negligence would sustain a *finding* of violation. However, with respect to the *issuance of an injunction,* the Court considered whether there was proof of scienter and finding none, denied the SEC an injunction. The Court cited the instant case for its determination that negligence would support an injunction under §17(a)(3). In connection with this it is difficult to comprehend how one under §17(a)(3) can commit a fraud or deceive another without the required intent. It is evident that in the absence of a determination by this Court of the

applicability of *Hochfelder,* the Court in *at illis* was unwilling to hold that scienter played no part in the issuance of an injunction.

3. The finding by the Court of Appeals that the conduct of the petitioner "amounted to a kind of reckless disregard" was erroneous as it did not meet an equivalent criteria of scienter. The Court of Appeals cited *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38 (2nd Cir. 1978). In *Rolf* the Court, although using the term "reckless," held that *gross* negligence *plus* the violation of a fiduciary duty was sufficient to sustain a 10b-5 action for damages. The Court emphasized the fiduciary duty of the defendant, stating that it did not reach the question of "recklessness" which satisfies the scienter requirement, absent the presence of a fiduciary obligation (note 9). In the instant case there was no fiduciary obligation involved. In *Berman v. Richford Industries,* CCH Sec. L. Rep. ¶96,518 (S.D.N.Y. 1978) The Court stated that the negligence standard posited by the *Rolf* Court was, absent the presence of a fiduciary obligation, not "recklessness." Other *Rolf* citations have emphasized the fiduciary obligation in discussing whether the truncated version of the Second Circuit should be applied in their Circuits. See, *In re Gap Securities Litigation,* CCH Sec. L. Rep. ¶96,709, pp. 94,750, 94,751 (N.D. Cal. 1978); *Resource Investors Group v. Natural Resource Investment Corp.,* cited supra.

4. The District Court found in the case at bar that to aid and abet, "knowledge that a violation is being committed and intent to further the illegal act is not required" (P. App. 49a), and applied a negligence standard. The Court of Appeals in its partial affirmation approved this standard. *Hochfelder,* it is submitted, required of the Court a different reading. The conclusion of the Court of Appeals appears illogical in any event. As was stated by the Fifth Circuit in *Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 95 (5th Cir. 1975), citing *SEC v. Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974) cert. den. 420 U.S. 908 (1975):

> The scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing. A remote party must not only be aware of his role, but he should also know when and to what extent he is furthering the fraud.

See, *Resource Investors Group v. Natural Resource Investment Corp.*, cited supra (absent the factors of knowing and substantial assistance precludes any secondary liability for the violation of others citing *SEC v. Coffey*, supra). In *Monsen v. Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793 (3rd Cir. 1978), the Court stated:

> Knowledge of the underlying violation is a critical element in proof of aiding and abetting liability, for without this requirement financial institutions, brokerage houses and other such organizations would be virtual insurers of their customers against security law violations . . . mere unknowing participation in another's violation is an improper predicate to liability.

a statement which is equally applicable to enforcement actions where the consequences are more severe. In the instant case there was neither proof, claim nor finding that the petitioner was aware that the underwriter had contrived the number of shares sold by it. The District Court found here that the petitioner had a "cavalier attitude' (P. App. 50a bottom).

5. The cases cited by the respondent (R. Br. p. 7) are either inapposite or serve to underscore the conflict in the Courts of the various Circuits as to the application of *Hochfelder*. *American Realty Trust* and *World Radio Mission*, both cited by the Respondent, have been treated in Petitioner's Main Brief (pp. 12, 13). Respondent also cites to *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970) and *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966). Both *Pearson* and *Van Horn* were decided sometime prior to this Court's decision in *Hochfelder*. Both involved an application for a preliminary injunction and both involved the sale of unregistered stock, a violation of §5 of the 1933 Act, as to which no intent to violate need be shown. *Pearson* cited and relied on *Van Horn*. In *Pearson* an application for a preliminary

injunction was denied and the case dismissed without trial. The denial was affirmed but the action was restored for hearing on the merits. *Van Horn* has been overruled by *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977) (referred to in petitioner's Main Brief, p. 12). *Sanders* was decided after remand by this Court for reconsideration in the light of *Hochfelder*. The Securities and Exchange Commission appeared in *Sanders* as amicus curiae. The respondent's statement that petitioner's reliance on the cited case is "unwarranted" (R. Br. p. 7) is absurd. The case is squarely on point.

6. In *Hochfelder* this Court expressed its concern that individual sections of the 1933 and 1934 Acts be interpreted as part of a consistent scheme of regulation. The holding of the Court of Appeals in the instant action does violence to such expression. If scienter is not to be required for enforcement actions under §17(a) and if private actions for damages are recognized under that section (as several circuits have already held), the effect would be to negate limitations on private recoveries for negligence contained in §§11 and 12 of the 1933 Act (P. App. 19a). The Court of Appeals here recognized this conflict but added that the issue of whether there is an implied right of private action under §17(a) was open in the Second Circuit.

7. It is submitted that upon reversal of a major portion of the injunction the Court of Appeals erred in failing to remand the action to the District Court for a determination as to whether or not the District Court would issue an injunction in light of such substantial reversal. The District Court which heard and could assess the credibility of the witnesses, particularly of the Petitioner, has broad discretion in the issuance of injunctive relief in SEC actions. It is one thing to have been held to have gone astray in connection with one aspect of one transaction and it is another to have been guilty of three violations in connection with the same public offering. The District Court on remand might well have determined that an injunction against the petitioner attorney was not warrnted. The petitioner

was unfairly deprived of such opportunity. An injunction is a harsh remedy and against an attorney, harsher yet. As the Court in *SEC v. Blatt,* cited supra, note 28, stated, experience has shown that an injunction is much more than a 'mild prophylactic', a term often used by the respondent.

The Court in *Hecht Co. v. Bowles,* 321 U.S. 321 (1944), at page 329, said:

> The historic injunctive process was designed to deter, not to punish. The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy are practical and have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs . . .

CONCLUSION

The application herein presents meritorious questions of a kind which require determination by this Court. As indicated there are sharp conflicts of opinions in the Courts of the various Circuits as to the application of this Court's opinion in *Hochfelder* and such questions are likely to arise in other cases.

For the foregoing reasons, your petitioner respectfully prays that a Writ of Certiorari issue to the United States Court of Appeals for the Second Circuit to the end that this cause may be reviewed and determined by this Court and so much of the said judgment of the Court of Appeals as affirmed a judgment of the District Court be reversed and for such other, further and different relief as may be just.

Dated: New York, New York
February 21, 1979

Respectfully submitted,

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